

Making the Earth flat

The Politics of Tax Reform in Estonia and Norway

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Foreword

If anyone had told me when I started studying political science that I would write my thesis about taxation, I would not have believed them. I was interested in political economy and in using insights from the Intermediate Subject that I had taken in Economics, but tax policies had always seemed complex and unexciting to me. My interest was triggered when I as an exchange student in Finland wrote a paper about the economic reforms of Estonia following their return to independence. One of the policies some observers claimed had led to the successful transition of the small Baltic country was the introduction of a flat tax. When I returned to my studies after a couple of years of working in politics, I thought it would be interesting to look into why Estonia had been the first European country to introduce such a reform. The fact that the flat tax had since spread to several other Central and Eastern European countries made it even more interesting. I knew that the same proposal had been discussed also in Norway, but it was my supervisor Bent Sofus Tranøy who first suggested that I should make the study into a comparison of the two countries. I was surprised to discover that the politics of taxation had been left almost untouched by Norwegian political scientists. This seemed like quite a paradox to me, as taxation in a sense is the very foundation for all other politics. Though the subject still seemed complex, I looked upon it as a challenge and agreed to my supervisor's proposal.

This was however only one of the many times when Tranøy came up with interesting suggestions and ideas. When I first sent him an e-mail in November 2005 and asked if he would be interested in supervising me, I had just moved back to Finland and I was struggling to get started on the work with my thesis. But his quick reply where he immediately took an active interest convinced me that those few ideas I had could actually turn out to be an interesting study. Tranøy also knew from his own experience how lonely it could feel to write a thesis in another country, far away from your fellow students. I am extremely grateful for the way he "saw" me and encouraged me to go on. The success of the book he published this spring meant that

Tranøy was quite busy the last months, but he always managed to find the time to give me valuable comments, even if it meant calling his cell phone on the tram, in the train or while he was waiting at the (wrong!) gate in the airport.

The friendliness I met on my visits to Estonia was truly extraordinary. I would first of all like to thank my friends Ulrika and Jaan who let me stay in their apartment in Tallinn. We had many interesting discussions, and their contacts and knowledge of Estonian politics provided me with a lot of help in my study. I owe an extra thanks to Ulrika for helping me with translations of Estonian texts I would otherwise not have understood. The staff at the Riigikogu provided help beyond what one would expect from a parliament's information service. I am especially grateful to Helin Noor who even helped me find contact information to former politicians who haven't been in the parliament for many years. Both formerly and still active politicians were almost without exceptions willing to give of their time in order for me to interview them. I owe them all my gratitude, but special thanks are due to Madis Üürike, Heiki Kranich and Mart Laar who also helped me straighten out some misunderstandings through e-mail. I am similarly grateful to all my respondents in Norway, with a special thanks to professor Ole Gjems-Onstad who also answered some of the questions that I faced in the writing process.

Being part of a family where everyone is interested in languages definitely has its advantages. I am extremely grateful to my mum, dad and brother who have all helped me out with reading parts of the thesis and correcting my English. Any remaining mistakes in the text are most likely to be found in sentences that I have written after they had the chance to correct it.

Last but not least, I wish to thank my wife Hilla for her loving support through the whole writing process. Now you won't have to listen to my worries anymore!

Joensuu, October 2006

Per Kristian Nielsen

1. Introduction

Why has the idea of a “flat tax” been spreading across Central and Eastern Europe during the last decade, and why has the same idea not been accepted in the West? What can explain why Estonia became the first country in Europe to introduce the flat tax, while the same proposal in Norway, though at times reaching the agenda, has never been seriously considered for adoption? When a candidate in the 1992 US primaries suggested introducing a flat tax, the idea was ridiculed as having originated with the “Flat Earth Society”¹. Is introducing a flat tax really so impossible in the West that it is justified to compare it to trying to make the earth flat? If it is, what are the mechanisms that make it so difficult? And what mechanisms and preconditions can explain why such radical reforms are still sometimes possible?

Taxes on income were not generally introduced in most of the now industrialized countries until the end of the 19th and in the beginning of the 20th century. Until then most states had mainly financed their expenses through different excises and duties on a vast number of items and services. As voting rights were gradually expanded, the working classes began to demand a fairer distribution of the tax burden and that progressive taxation should be used to reduce income inequalities. The first income taxes were generally small and only to be paid by the high earners, but the costs of the First World War led to increases in both the numbers of tax payers and the rates applicable to the highest earners. Though many of the war taxes were later rolled back, “the belief that taxation policy could be used as an instrument of redistribution in modern society was no longer seriously questioned” (Steinmo 2003:210-211). With the Second World War an even larger proportion of the population had to pay taxes, and the tax was made increasingly progressive, pushing the marginal tax rates up to dramatic levels (e.g. a top marginal rate of 97,5% in the UK (Steinmo 1993:25))

¹ The candidate was Jerry Brown, the closest one to beat Bill Clinton in the 1992 Democratic primaries (http://en.wikipedia.org/wiki/Flat_tax)

After the war the dominating economic doctrine was that the government should play a more important role in managing the economy. Within the area of tax policy, this meant that the steeply progressive income taxes were kept in place to reduce income inequality, while a range of different tax exemptions gave incentives to behave according to what the government saw as favorable. (Steinmo 2003:209-213)

From the end of the 1970s it became increasingly clear that these complex tax systems did not have the intended results on equity and, more importantly, had severe negative consequences on the efficiency of the whole economy (ibid:213-4). Economists started advocating simpler tax systems that would minimize the negative efficiency effects of taxation and make the benefits given to certain groups more transparent. Significant tax reforms that reduced the top tax rates, the number of brackets in the income tax and the number of exemptions, were thus undertaken in all Western countries starting from the beginning of the 1980s (Peters 1991:276).

As a part of this trend toward simpler and more efficient tax systems the idea of a “flat income tax” was re-introduced. The most famous concrete proposal for such a reform was presented by the American economists Robert E. Hall and Alvin Rabushka (1985), who suggested that a single tax rate applying for all income above the threshold of a personal allowance should replace the complicated systems of tax brackets and deductions. The flat tax would seem to be a natural continuation of the type of tax reforms that had been implemented in the eighties and the beginning of the nineties (Sandmo 1999:206). But though it caused a lot of debate, no Western country decided to carry out the proposal.

Starting from the mid-1990s, however, the idea of the flat tax became increasingly popular in the former communist countries of Central and Eastern Europe. The proposal has so far been introduced in Estonia, Latvia, Lithuania, Russia, Serbia, Georgia, Ukraine, Slovakia and Romania. The fast spread of the reform in these countries brought the idea back to the agenda also in Western Europe. The proposal caused fierce debate in Germany ahead of the elections in 2005 when it was promoted by the man the CDU had suggested as the next Finance minister, and in the

UK the same year the Conservative Party set up a commission to examine the possibility of introducing the flat tax there. Still, so far no Western country has taken the step to actually leave their established progressive tax systems.

Why has the so-called “flat tax revolution” been restricted to Central and Eastern Europe? The greater empirical backdrop of this thesis is the apparent paradox of why this seemingly natural “next step” in the development of tax policy has not been taken in any of the established democratic market economies in the West, while it has been implemented in many of the former communist countries of the East. To give a clear answer to such a broad question is however beyond the reach of a single study. Limiting my scope, I will focus on two cases and make a closer investigation of one country that has introduced the flat tax and one that has not. For this purpose I have chosen Estonia, the first European country to introduce the flat tax, and Norway, a country where the proposal has been up for consideration but where it has not been carried out.

When Estonia introduced the flat tax in 1994 it was in a period of both political and economical crisis. The small Baltic country had only just regained independence and its people were struggling to return to democracy and market economy, all the time fearing that their newly won freedom could still be taken away from them. The young government of Mart Laar wanted to make a clear break with the Soviet past through a quick and radical liberalization of the economy. As a part of this, the progressive tax system that had been introduced only a few years earlier was replaced by a simple flat tax rate of 26 percent for all income above a personal allowance.

Following the trend in the direction of more simple and less progressive tax systems, Norway undertook an extensive tax reform in 1992. A main result of the reform was that salaries would continue to be taxed progressively, although with lower top rates, while capital and business income would be taxed at a flat and lower rate. Both experts and decision makers agreed that the reform was a major improvement compared to the earlier system. However, the gap between the tax rates on different types of income was soon considered to be a problem, mostly because of the

incentives it created towards redefining labor income as capital income. In the search for new solutions, the flat tax proposal was brought to the agenda in 1997, but without leading to any new reform. In 2001 a centre-right government was brought to power. All of the coalition partners and its support party in parliament had programs that either stated directly or at least could be interpreted as supporting a change in the direction of a flat tax. However, rather than introducing a actual flat tax, the ensuing tax reform only made the taxation on labor income somewhat less progressive, while introducing a new model for the taxation of capital income.

Scholars within the historical institutionalism tradition have showed how political inertia can stem from a process of “path dependence”. Certain policies, once adopted, may create obstacles that make it difficult to change them. Initial choices of policy may thus lead to a certain “path” that it is hard to break out from. Though the path dependence theory gives powerful explanations for the difficulties of political reform, this kind of literature has been accused of being better at explaining why change is not possible than at explaining when it is (Thelen and Steinmo 1992:14). The “Multiple Streams” model on the other hand, tries to explain the conditions that have to be fulfilled in order for great reforms to actually happen. The model argues that there are three “streams”, *problems*, *proposals* and *politics*, and that major changes can be made only when the three streams are joined together. That is, “a problem is recognized, a proposal is available that can be related to that problem, and the political conditions are right” (Kingdon 1994:216). This is however most likely to happen when certain circumstances lead to the opening of “policy windows”, extraordinary moments in time which “policy entrepreneurs” can take advantage of to actively couple the three streams.

Taxation is a policy area commonly viewed as especially prone to inertia. Indeed, it has been argued that in this field politicians often find that “non-decision-making is preferred to decision-making” (Rose and Karran 1987:5). In examining the politics of taxation in an established capitalist democracy like Norway, we would thus expect to find evidence suggesting the presence of the mentioned path dependence

mechanisms. Estonia on the other hand, had just returned to a democratic form of government after more than fifty years of authoritarian rule, Communism and occupation, and the country had only a few years of experience with Western-style income taxation. We would therefore expect to find fewer such bindings there. The two countries reformed their tax systems in 1994 and 2006 respectively. Based on the Multiple Streams model, we would expect to find that both countries experienced a period of “open policy windows” in the time leading up to each of the reforms. Assuming that this is the case, I will limit the scope of the thesis further to a case study of each of these policy windows. The question that I seek to find an answer to is why the possibility for a tax reform offered by the “policy window” was used to introduce the flat tax in the first of my cases, but not in the second.

The theoretical ambition of the thesis is to incorporate the explanations of the path dependence theory into a revised Multiple Streams model. My claim is that what Kingdon (1984:138) calls “survival criteria” in the proposal stream model can provide the path dependence theory with a direction in which to search for the existence of “policy lock-ins”. The path dependence theory on the other hand provides the Multiple Streams model with an explanation of the forces of inertia that make the existence of a policy window and the coupling of the streams necessary conditions for radical reform. I will emphasize the fact that whether these conditions are fulfilled or not is a *question of degree*. As a part of this, building on the work of Keeler (1993), I will argue that certain situations may create extraordinary “macro-windows” which make great reforms possible.

The structure of the thesis will be as follows: the remainder of this introduction chapter will give a more detailed presentation of the flat tax proposal and take a closer look at the economical theories concerned with the efficiency of taxation, before I present the scientific methods used in the study. Chapter two will present the theoretical framework of the thesis, and provide more detailed expectations as to what we will find in the empirical chapters. Chapter three will deal with the case of Estonia. The first part of the chapter will describe the situation of Estonia at the time

of reform, giving a brief presentation of the economic reforms preceding independence, the tax system before the reform and the elections that led to the formation of the first Laar government. The second part will describe the reform process and take a closer look at the arguments, which I will organize according to the aforementioned “survival criteria”, and the “policy entrepreneurs” involved in the process. Chapter four on Norway will follow the same structure. It will first give an account of the immediate history of tax politics preceding the reform and the elections of 2001, and then go into the details of the reform process, the arguments and the entrepreneurs. Chapter five will compare the two cases in light of the theoretical framework, before I conclude in chapter six.

1.1 The flat tax proposal

An income tax system is “progressive” if it taxes a greater percentage of the income for those with larger incomes, and “regressive” if it taxes a larger percentage of the income from people whose income is low. The strict definition of the term “flat tax” would be an income tax that is neither progressive nor regressive, but *proportional*. That is, everyone pays the same percentage of their overall income in tax. The proposal presented by Hall and Rabuschka (1985) and the reforms that have been introduced in Central and Eastern Europe have included a personal allowance that would not be taxed. Such a tax would in reality still be progressive, as persons with a lower income would pay a smaller share of their income, and people under such a threshold would not pay tax at all. It has nevertheless become common to refer to these systems as systems of “flat tax”. Hall and Rabuscha (1985), and the majority of flat tax supporters, have furthermore argued that a central element of the flat tax is that all existing deductions and tax allowances should be removed. Following the conventional use of the term this thesis will use “flat tax” as meaning an income tax system with *one single tax rate which applies to all income above a certain threshold*. I will generally take it as given that implementing the flat tax means abolishing all other deductions. However, I will include the possibility that also a

more “watered-down” version of the proposal which leaves some deduction possibilities in place can be counted as being within the definition of a “flat tax”.

Advocates of the flat tax have first of all argued that such a system would be *fair*. The system would treat everyone equally, but it would still be redistributing, since making everyone pay the same or nearly the same share of their income means that the highest earners would pay more than the lowest ones. It has been argued that since the multitude of tax deductions generally benefits the highest earners, the current progressive systems do not actually serve its redistributive purposes. Replacing them with a generous personal allowance would therefore leave the lowest earners better off.

The flat tax has also been favored for its *simplicity*. The complex systems of different tax rates and deduction possibilities are *costly to administer*. Society wastes a lot of resources both on the tax administration that is needed to check that everyone follows the laws, and on tax lawyers in private companies that spend their time trying to find loopholes and ways to adapt in order to pay less tax. In addition to legal, but at times perhaps morally dubious, tax *avoidance*, a complex system also encourages illegal tax *evasion*. The flat tax, it is claimed, would both cut administration costs and significantly reduce tax evasion and corruption. The complexity of the progressive systems has also been seen as a problem for *democracy*. In a society where everyone is obliged to pay taxes and where citizens are supposed to at least indirectly decide how much taxes should be levied, it would be natural that these same citizens would be able to understand how the tax system works. This is however not the case in most of the established democracies of the West. A flat tax, it has been argued, would be a system everyone could relate to.

Finally it has been argued that a flat tax would contribute to a more *efficient* economy. This argument deserves a closer explanation. All taxation of labor influences the choices potential employees make in terms of how much they want to work and potential employers in terms of how much they will want to offer. The result is an *efficiency loss* for the whole economy. In its simplest form this can be

explained by thinking of a situation where an employer is willing to pay 150 NOK to get a job done, and an employer is willing to do the job for 100 NOK. In a society with no taxation on labor, an agreement would be made settling on a salary somewhere between the two sums. On the other hand, if the employee faces a marginal tax on labor of 50 percent, the employer would have to pay 200 NOK in order for the worker to get 100, and no transaction takes place. The example can be taken further by assuming that the employer for example is a homeowner who wants to have his house painted. The employee is a professional painter who would be willing to paint the house in 100 hours if he gets 10 000 NOK for the job. With a marginal tax of 50 percent this means that the homeowner must pay 20 000. If the homeowner also has a marginal tax of 50 percent, he will need to earn 40 000 in order to pay the painter. Rather than doing the work he is good at and using the salary to pay the painter, he may thus decide that he would rather paint the house himself. Because he is not a professional, he uses 150 hours on the job. The efficiency loss of taxation would in this case be the 50 extra hours that the society could have used in a more productive way. (NOU 1999:7:79)

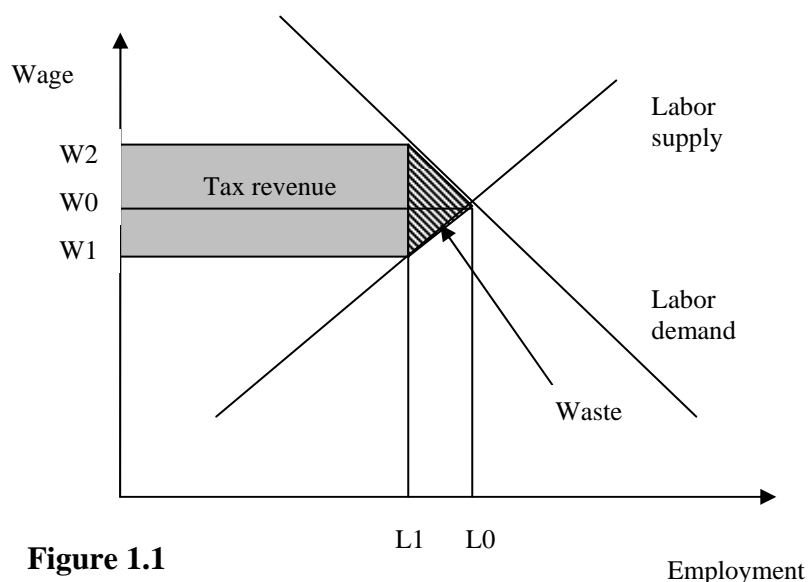


Figure 1.1
The efficiency loss of
taxation

The waste or efficiency loss as a result of taxation is illustrated in more detail in figure 1.1. The demand for labor is assumed to fall when wages increase, while the

supply of labor is assumed to go up. Without taxes the labor market is in equilibrium with a wage W_0 and a total employment of L_0 . But a tax on labor puts a wedge between the wage that the worker receives, which is now W_1 , and the wage that the employer has to pay which has been increased to W_2 . The result is that the total employment is reduced from L_0 to L_1 . The tax revenue is equal to the grey area in the figure, but this is smaller than the reduction in the welfare for both employers and employees, which is the sum of the grey and striped areas. The striped area thus represents the “waste” resulting from the tax.

The flat tax is supposed to reduce the efficiency loss of taxation because it is the *marginal tax* that is the basis for the adaptations of the employers and employees compared to a situation without taxes (NOU 1999:7:14). In other words, the higher the marginal taxes, the greater the efficiency loss. The common acceptance of this theory was a main reason why the top marginal rates were cut in most OECD countries starting from the 1980s. But because progressive taxation always means that the marginal tax will be higher than the average tax for all taxpayers, economic theory suggests that the efficiency loss could be further minimized in a flat tax system.

The proponents of the flat tax therefore claim that revenue would increase as a result of an increase in employment. Economic theory has however showed that a tax has two effects on an individual's labor supply. First of all the lower wage means the worker is left with less money. This means that he or she will want to spend less of all “goods”, including leisure. This “income effect” indicates by itself an *increase* in labor supply. On the other hand, because leisure is not taxed, it becomes relatively cheaper to work less. The “substitution effect” thus indicates that the labor supply would *decrease*. The sum of these two effects is not clear from economic theory. This means that the exact effects on employment of the tax cuts resulting from a change to a flat tax are hard to predict. (NOU 1999:7:81-84)

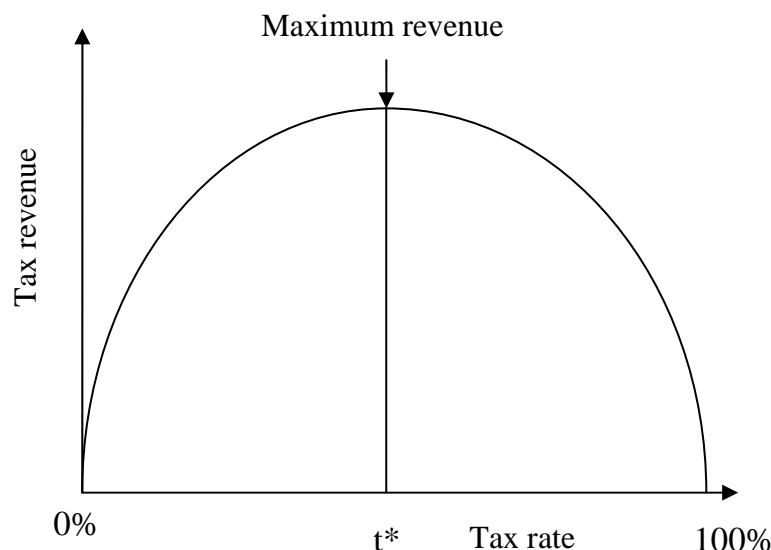


Figure 1.2
The Laffer curve

Some flat tax advocates have also been influenced by the idea that cutting taxes might in itself *increase* revenue. The argument is often based on the so-called “Laffer curve” (figure 1.2), named after the economist Arthur Laffer who popularized it. The theory builds on the fact that with zero percent tax, the tax revenue would of course be zero. At the opposite extreme, a tax rate of 100 percent would also mean zero revenue, as there would be no incentive to work. The argument is that between these two points there would have to be a curve with a top point, which gives the maximum possible tax revenue. If the tax is already set higher than this level, then cutting the tax will increase the revenue. The existence of such a curve seems obvious, but determining on which side of the curve any given country has placed its tax burden is not necessarily an easy task. Some economists have in fact argued that it is doubtful whether any western country has ever been on the right hand side of the Laffer curve. (Begg et al 2003:238)

1.2 Methods

This thesis will be based on two different case studies. The first case is the “policy window” for tax reform that Estonia experienced in the period leading up to the

introduction of the flat tax, limiting my study to the time from the elections of 1992 until the reform was put to a vote in parliament in December 1993. The second case is the “policy window” that Norway experienced for tax reform in the period leading up to the tax reform of 2006, and I will limit this to studying the time between the elections in September 2001 and the budget process in the fall of 2005. Both cases will however include some necessary background information about the tax systems and the political conditions before the actual policy window.

The dependent variable is the type of tax system that the countries chose during these policy windows. The question that I am asking is why the flat tax system was chosen in the first of my cases, while in the second case the decision was to make only minor changes to the existing progressive system. As already mentioned, the tax system adopted in Estonia was strictly speaking not completely flat, since the personal allowance in a sense means that the system has two rates, zero and 26 percent. It could therefore be argued that it would make sense to talk of a more gradual scale of progressiveness, and that Estonia’s tax reform was merely “flatter” than the one adopted in Norway, which also went in the direction of less progressive taxation. For the sake of analytical clarity I will however, based on the less strict definition provided in the preceding subchapter, choose to treat the dependent variable as a dichotomy, with the options “flat” or “progressive”.

Case studies have a distinct advantage when we ask “why questions” about contemporary sets of events over which the investigator has no control (Yin 2003:9). Because case studies often deal with situations where there are many more variables of interest than data points, this type of studies especially benefits from theoretical propositions to guide the data collection and the analysis (ibid p.13-14). The next chapter will therefore present theories that provide the study with clear expectations of what I will find in the empirical study of the two cases. The theories I intend to use do not claim that any single cause can explain the difference in outcome on the dependent variable. My expectation is rather that the outcome was a result of what Ragin (1987) calls “conjunctural causation”. That is, that “a phenomena or change

emerges from the intersection of appropriate preconditions – the right ingredients for change” (ibid p.25). If one of the essential conditions is not present, the phenomenon will not occur. I will return to the question of the conjunctural nature of the explanation in the theory chapter and in the conclusion.

In order to secure the construct validity of a case study it is important to use multiple sources of evidence (Yin 2003:99). In the case of Norway I have made use of a number of official documents, including governmental green papers, white papers and parliamentary recommendations, as well as newspaper articles and some secondary literature. I have interviewed one central political actor from each of the parties of the government and the government’s “support party” at the time of the study: former Minister of Finance, Per-Kristian Foss from the Conservative Party, former Minister of Oil and Energy and vice-chairman of the Christian Democratic Party, Einar Steensnæs, political advisor to the chairman of the Liberal Party Geir Olsen, and tax spokesperson for the Progress Party, Gjermund Hagesæter. I have also interviewed Ole Gjems-Onstad, a tax professor that has been actively involved in the debate on tax reform and the flat tax in particular.

In the Estonian case the collection of data was made more difficult by the fact that the object of study is further back in time, but most of all by my lack of knowledge of the Estonian language. I have thus had fewer possibilities to make use of official papers and newspaper articles (though some are included), and I have had to rely more on secondary literature and personal interviews. To compensate for the lack of alternative sources, I have interviewed a larger number of the people involved in the tax reform than in the Norwegian case. A total of nine high-ranking politicians from the time of the flat tax reform agreed to speak to me: former Prime Minister Mart Laar, former Minister of Finance Madis Üürike, former leader of the Social Democrats and Social Minister Marju Lauristin, former chairman of the Rural Centre Party Ivar Raig, former vice-chairman of ERSP Viktor Niitsoo, former chairman of the Isamaa faction Tiit Sinissaar, former chairman of the Moderates faction Toivo

Jullinen, former Minister of Reforms Liia Hänni, and former member of the Finance Committee from the Estonian Liberal Democratic Party Heiki Kranich.

The interviews were of a *semi-structured* format (Rubin and Rubin 1995:5). I had prepared an interview guide with the questions that I planned to ask, but the interviews were conducted as more relaxed conversations. Sometimes the respondent would answer several of the questions I had planned to ask, without me having to interrupt. New information at times triggered new questions that I had not prepared, and some questions were more specifically formed to only one person or persons from only one party. All of the respondents agreed to let me record the interviews². When I planned the study, I expected that the language could constitute a problem for the interviews in Estonia. I was however pleasantly surprised to discover that all of the respondents spoke excellent English and no interpreter was needed. The interviews in Estonia were thus all conducted in English, except the interview with Madis Üürike, which was done in Norwegian/Swedish. The interviews with Norwegian politicians were also conducted in Norwegian. All of the quotes from the interviews not done in English are translated by the author.

All the informants have been e-mailed and asked to read through a draft of the chapter which they have contributed to. They have thus had a chance to approve the quotes that I have used, but also to correct any misunderstandings or mistakes in the facts as presented by the author. All the Norwegian respondents have in this way confirmed what they have been quoted on, except for professor Gjems-Onstad, who at that stage answered that he didn't have the time to contribute any further. In the Estonian case, eight out of my nine respondents answered and confirmed their quotes. They also contributed with many helpful comments that have been incorporated into the finished product. This kind of corrections by the informants is thus likely to have increased the construct validity of the study (Yin 2003:159).

² Both the recordings and the transcripts are available upon request. The author can be contacted on e-mail: perkristiannielsen@yahoo.no

The reform process that led up to the introduction of the flat tax in Estonia took place thirteen years ago. I therefore faced the challenge that some of the respondents had problems remembering all the details of how it all happened. This was however not a major problem when it came to the most important questions related to the way the decision makers were thinking at the time. On the other hand, there is a chance that the respondents have given me wrong answers. This might be simply because it is difficult to remember, but it may also be that the respondents, albeit unconsciously, try to make themselves “look good”. The flat tax has in hindsight been judged by many as a success and it has been quite popular in Estonia. There is therefore a chance that politicians that had been skeptic to the reform have wanted to downplay this and appear as if they had backed the proposal all along, or that respondents have tried to present themselves as having played a more important role than what was really the case. It is also possible that the arguments they presented as having been a base for their decision to support the reform, may have been influenced by information about the benefits of the system that they might have heard at a later stage. This kind of problems with the validity of my results are however likely to have been reduced by the relatively large number of respondents and the fact that they have all had the chance to read and make comments to drafts of what I have been writing. There are clear limits to how much a respondent can deviate from the truth when other witnesses will read it (Dahl 1988:77). If e.g. an earlier opponent would present her or himself as a supporter of the flat tax proposal, this would most likely provoke reactions from the respondents from the other parties.

Generally, only data that are confirmed by more than one independent source should be treated as historical facts (Dahl 1988:110). Some of the details of my account of the Estonian reform process, however, rely heavily on statements from one respondent. In these cases I have tried to make it especially clear that this is the story *according to* the source in question. Three of the respondents, Mr. Laar, Mr. Kranich and Mr. Üürike, had somewhat different versions of some of the details regarding the procedure of the reform process. Most of the disagreements have easily been corrected by the persons in question, through emailing new questions based on one

respondent's comments to the others. In the few cases where the disagreement remained, I have made it clear in the text whose information I have built the story on, and marked the disagreement in a footnote. None of these details are however of any importance to the basic findings of the study.

My own political affiliation is also an issue that could be considered relevant to the reliability of the study. At the time of the 2001 elections I was vice-President of the Young Christian Democrats and I later worked as an adviser for the Christian Democratic Party in the Oslo City Council and in the Parliament. Following the elections of 2005 I became a 2.deputy member of the Parliament for the same party. My affiliation to the Christian Democrats was known by the respondents from the other Norwegian parties. On the one hand, familiarity with the environment might be positive in the sense that it reduces the social distance between the interviewer and the informer (Thagaard 1998:91). Rubin and Rubin (1995:113) have argued that "elite interviews" with people in high positions are sometimes difficult because they might brush the interviewer off with formal statements of the sort they offer to the press and because they often have limited time. The fact that the Norwegian respondents knew my background might have made them more willing to speak to me, and made them less likely to treat me with the "top-down" attitude that young students may otherwise meet. On the other hand, there is also a risk that my background has influenced how they chose to answer my questions in a way that reduces the reliability of the data from the interviews. Though I made it clear that my role was that of a neutral student, on one occasion I noticed that one of the respondents backed away from speaking negatively about "my" party. After I encouraged him to also tell me the details not favorable to the Christian Democrats, he seemed however to give me his honest opinion³. My political background may also pose questions as to whether the study could in any way be flawed by political bias. I have however not in any way been involved in the government's or the

³ The interview in question was with Olsen from the Liberal party, in discussing the internal debates in the government on reductions in the number of tax exemptions.

parliament's work on tax policies. I embarked upon the study without any strong opinions in any direction regarding the tax reform of the past or the desirability of introducing a flat tax, and I have all the time been conscious of the need to stay as neutral as possible. Overall, I consider the possibility for any serious errors in the data as a result of my party background as small.

Case studies have been criticized for providing little basis for scientific generalization. Yin (2003:10) has however argued that case studies, like scientific experiments, do not represent samples from which the purpose is statistical generalizations, but that the goal of a case study is to expand and generalize theories. By testing hypothesis on “positive” cases where a phenomenon of interest occurs and closely matched “negative cases” where it doesn't, one can develop theories further (Pierson and Skocpol 2002:711). Case studies can form the basis for *analytical generalization*, which provide a “reasoned judgment about the extent to which the findings from the study can be used as a guide to what might occur in another situation” (Kvale 1996:233). A researcher may thus argue that the results from a case study are *relevant* for the understanding of a greater context (Thagaard 1998:185). If the study specifies the supportive evidence and make the arguments explicit, the readers may themselves judge the soundness of the generalization claim (Kvale 1996:233). Although this study has as a backdrop an interest for a larger empirical question, namely why the flat tax has been introduced only in Central and Eastern Europe and not in the West, I do not claim that the results of the study of my two cases are *generalizable* to the whole “universe” of European countries. I will however turn back to the question of generalization in the conclusion and provide some arguments for why the results from the study may also be *relevant* for the understanding of the differences in tax policy across the continent. My modest ambition is that a student trying to explain the same phenomenon with other European countries as cases would find my results *helpful* to his or her study.

2. The theoretical framework

The concept of *path dependence* has frequently been used to explain how policies adopted in the past may influence the choices of policy in the present. As the name suggests, the theory argues that today's choices are "dependent" on the "path" that has been chosen at an earlier stage. Alternative policies, which may have been just as available options at an earlier stage, may later become difficult to change into because the path that was initially preferred has led further away from this alternative path. Paul Pierson (2000:251) conceptualizes path dependence as "a social process grounded in a dynamic of "increasing returns"". The term "increasing returns" is taken from economics where it has been showed that, under certain circumstances, once a particular choice has been taken in terms of a product's technology or design, it will be more and more profitable to continue producing it in that same way. Though it may be the result of a historical accident, the product that is "first out the gate" may get such a significant advantage that later competitors with superior technology are unable to compete (ibid). The *relative* benefits of continuing down the same "path" increase with each step taken, and, conversely, the cost of switching to another alternative becomes greater (ibid p.252). Pierson draws many helpful contributions from this thinking in economics to the field of political science. However, it is not clear that the term "increasing returns" is entirely translatable to politics. First of all, Pierson does not make it completely clear what these "returns" consist of in the political realm. Furthermore, path dependence mechanisms can in my opinion also clearly be present, even if the relative benefits of a policy choice do not continue to increase over time.

Margaret Levi (1997:28) defines path dependence as a concept that claims that "once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice." Levi prefers to use the metaphor of a tree, where one may chose to climb different branches, but where it is

still possible to turn around or to clamber from one branch to another (ibid). However, I believe it is still helpful to think of a path in the forest. After choosing one specific path, the alternative path might turn in another direction. It may however afterwards continue in parallel to the chosen path, so that the distance between the two is constant, or it might even come closer. The important thing is that it is normally uncomfortable to change paths. You need to cross through the forest, maybe getting your feet wet and your face scratched by branches from the trees that block the way. The obstacles blocking the way to the other path may have many different causes. The chosen policy might directly or indirectly cause the creation of institutions that fundamentally shape the politics of the future, or it may lead people to adapt in ways that are hard to reverse. Through psychological mechanisms a policy may also shape people's minds and ways of thinking. Or the security of keeping the status quo may create fear of the unpredictable consequences of changing the policy. The result is however that once a particular policy has been adopted, the choice of policy may seem to be "locked in", "even though it originated by accident, or the factors that gave it an original advantage have long since passed away" (Pierson 2000:264).

It is important to emphasize that it is not *impossible* to change policy. It is just much more comfortable for the decision makers to keep walking on the same path. This means that if they are to change paths and suffer the difficulties that this entails, they need to have a good reason for it. It may be that the path becomes narrower and more difficult to walk, that is, the chosen policy appears to lead to *problems* that are disturbing to the decision makers. The path may even come to a complete dead end, giving the decision makers no choice but to change paths. In other cases it may be necessary to wait until the path comes to a *clearing*, where fewer trees block the way to another, more desirable, path. That is, an *appropriate moment in time* when certain circumstances make it easier to change policy.

The *Multiple Streams model* tries exactly to explain the conditions that need to be fulfilled in order to change policies that may otherwise be resistant to reforms.

Building on Cohen, March and Olsen's "Garbage can model", John Kingdon (1984) originally developed the Multiple Streams model to explain agenda change. The aim was to study why issues "came to be issues in the first place" (ibid p.2). Zahariadis (2002) has however showed that the model can be used to explain the full policy formation process, including both agenda setting and decision making. He has furthermore demonstrated that even though the model was based on studies of the US, the Multiple Streams model is applicable also to European parliamentary systems. Grimmeisen (2004) has also used the theory to explain differences in pension policy in Hungary and the Czech Republic.

The model describes a policy formation process as having three streams: *problems*, *proposals* and *politics*. The different streams "float around" independently of one another. In and around the government, different problems are given emphasis at different times, policy proposals are being developed independently of whether or not they are solving problems, and political events change according to their own dynamics. In order to make important policy changes, these three streams need to be joined together. An important *problem* needs to be on the agenda, giving the policy makers a good reason to leave the comfort of continuing with status quo. Then a *proposal* that can be seen as a solution to this problem needs to be present. And finally the *political* conditions need to be favorable to the change that the proposal suggests. The three streams are not likely to be coupled without the presence of one or more "*policy entrepreneurs*". Individual actors that are willing to make an effort in order to see through their "pet proposal" must actively couple the streams. This may however not be possible unless certain circumstances lead to the opening of what Kingdon calls a "*policy window*", special moments in time where it is easier to break the forces resistant to change. (Kingdon 1994:216)

Within the proposal stream, Kingdon mentions certain criteria which need to be fulfilled in order for the proposal to survive: "technical feasibility, value acceptability within the policy community, tolerable costs, anticipated public acquiescence, and a reasonable chance for receptivity among elected decision makers" (Kingdon

1984:138). For the sake of analytical clarity, I will choose to shorten these down to three. *Value acceptability* I will understand as applying to a policy community which is defined as including the elected decision makers, and both their own values and their understanding of what is acceptable to the values of the general public. My second category I choose to call *technical and political feasibility*, which in addition to the purely technical challenges also will include the political difficulties of adopting the proposal. My final criterion covers what Kingdon calls “tolerable costs”, but allowing for the possibility that the proposal might also increase revenue, I choose to call it *budgetary implications*. My claim is that it is primarily by influencing these three survival criteria that the earlier mentioned path dependence mechanisms may create fundamental obstacles to change. To return to the metaphor: like most streams in nature, the proposal stream is running in a path. The proposal path chosen at one point in time will later significantly affect whether an alternative proposal will be judged as being acceptable to people’s values, as technically and politically feasible to carry out and as having acceptable budgetary costs.

By using the insights from the path dependence theory to explain a proposal’s survival in the proposal stream, I thus seek to combine the two theories into one model. The survival criteria from the Multiple Streams model provide the path dependence theory with a direction as to where to look for “lock-in” mechanisms, while the path dependence theory provides an explanation of why it is necessary to fulfill all the conditions of the Multiple Streams model in order to carry out radical reform. My revised Multiple Streams model will thus both explain how great changes may happen and provide an explanation of the mechanisms that may inhibit change.

The Multiple Streams model puts up a set of *necessary* conditions for change. In other words, it implies that a missing value on any of the variables is enough to stop the reform from being adopted. This does not mean however that the conditions are *sufficient*: a country with all the necessary conditions in place may still not undergo any reform. To get a nuanced explanation of when a proposal is indeed adopted, I believe it is fruitful to add to the model an emphasis on the fact that the independent

variables may vary in strength. First of all I will claim that the *seriousness* of the problem matters, arguing that the more serious the problem, the more likely it is that the proposal coupled to it will be adopted. Secondly, I will argue that when it comes to the survival criteria, it is more fruitful to look at the *extent* to which the proposal fulfills the criteria, than to make it a simple question of whether the criteria are fulfilled or not. The more problems the proposal has with the survival criteria, the less likely it is to be adopted. Third, whether the *political* conditions are favorable is obviously also a question of degree, and the more favorable they are, the more likely it is that the proposal will be adopted. Fourth, I will add an emphasis on the *centrality* of the position of the policy entrepreneur, arguing that the more central position the entrepreneur is situated in, the more likely he or she is to succeed in pushing through a proposal. Finally, building on the work of Keeler (1993), I will add to the model a distinction of different *sizes* of the policy windows, arguing that the larger the window, the more probable it is that the proposal will be adopted.

The assumption of the study is that both Estonia and Norway experienced “policy windows” for tax reforms in the periods under study. The fact that the “proposal” flat tax was adopted in the first of the cases but not in the second cannot be explained by any single factor. Rather, it is the claim of this thesis that the difference in policy choice can be attributed to differences in the seriousness of the problem that the proposal was attempted coupled to, the extent to which the flat tax proposal measured up to the “survival criteria”, differences in the political conditions, the centrality of the entrepreneurs favoring the proposal and the size of the policy window.

The remainder of this chapter will elaborate further on each of the three streams, the role of the policy entrepreneurs and the policy windows. Each of the subchapters will provide predictions as to what I might expect to find in the empirics of the two cases.

2.1 Problems

The definition of a problem involves both objective indicators and interpretation. Kingdon differentiates between a “condition” and a “problem”. “Conditions” are negative situations that we might deal with every day, but a condition becomes a “problem” only “when we feel we should and can do something to change them” (Kingdon 1994:218). This happens when the condition violates important values, when the situation in one’s own country compares unfavorably with the situation in other countries, or when we change the way we classify the condition into different categories (Kingdon 1984:116-118). Problems come to the agenda through more or less systematic “indicators”, through more dramatic focusing events or through feedback from existing governmental policies. Problems then might fade after being some time on the agenda. This may be because the government has addressed, or at least tried to address, the problem, because the conditions change, because people grow accustomed to a condition, or because new problems emerge that steals the attention. (ibid p.207)

In the area of tax politics, following the distinction between a condition and a problem, consequences of the tax system may be viewed as a problem by some and merely a condition by others, depending on their values or on the way they categorize the condition. Consequences that at one point were seen as merely a condition, or not even recognized as such, may also, in the light of new trends in economic thinking, be re-defined as a problem, although there has been no change in the condition. This may for example explain some of the increase in attention that was paid to the negative effects on the efficiency of the economy resulting from the high marginal income taxes starting from the 1970s. Economists recognized the effect as a negative condition, and after some time it was seen as a problem also by important political actors.

As we have seen in chapter 1.1, proponents of the idea of the flat tax claim that such a tax system will solve several different problems. In order for a proposal to move up on the agenda, it needs however to be linked to a problem that is “perceived as real

and important” (Kingdon 1984:121). One would in other words expect that which problem in particular the proposal is attempted coupled with will be an important factor in determining if the proposal will win through or not. Other things being equal, one would expect that the more *serious* and *urgent* the problem coupled to the proposal, the more likely it is that the proposal will gain support. Additional support would be expected if the proposal could address several such problems. If on the other hand the problem is not seen as very serious or urgent, policy makers may decide to look for another solution if the proposal in question involves too great political difficulties.

In our case, this would lead us to expect that:

1) The flat tax proposal was in Estonia coupled to a problem perceived as more serious and urgent than the problem coupled to the proposal in Norway.

2.2 Proposals

Within different policy areas there are different communities of specialists, including researchers, politicians, parliament staff, bureaucrats and lobbyists. Ideas are developed, tried out and tested in these communities through conferences and hearings, by publishing articles or books or by drafting proposals (Kingdon 1984:122). Kingdon compares the process by which proposals are picked from among the circulating ideas to that of a biological natural selection: “As molecules floated around in the “primeval soup” before life came into being, ideas float around in a “policy primeval soup” in these communities of specialists” (Kingdon 1994:218).

In the evolution of policy proposals, only some of the ideas will survive and from these even fewer will make it to the stage where they are seriously considered for adoption by the government. In order to survive, the proposals need to fulfill three “survival criteria”: value acceptability, technical and political feasibility and acceptable budgetary implications. As mentioned, my claim is that the extent to which the flat tax proposal meets these three criteria in a specific country may depend

on the existence of processes of path dependence which may seem to “lock in” the existing policy. I will go through each of them in turn.

2.2.1 Value acceptability

The first of the survival criteria is that the proposal needs to fit with the *values* and the way of thinking dominant within the policy community (Kingdon 1984:138). In the case of the flat tax proposal, I will define this as whether or not the proposal is seen as being *fair*.

Arguments on what would constitute a fair distribution of the tax burden have historically been based on a number of different principles. The *benefit principle* states that the tax burden is fair if it reflects a direct payment for the goods that the individual receives from the state (Hoff 1998:104). Adam Smith ([1776] 1961:350) argued that everyone should contribute “in proportion to the revenue which they respectively enjoy under the protection of the state”. This principle can however be used to defend both a regressive and a progressive taxation, depending on how one calculates the benefits different income groups derive from the state. John Stuart Mill ([1848] 1994:171) claimed that that it is the poor who would have the most to loose if there were to be no state, but that “government must be regarded as so pre-eminently a concern of all, that to determine who are most interested in it is of no real importance”. Instead, he argued that the tax system should be made so that “the least sacrifice is made on the whole” (ibid p.169). This would in Mill’s opinion be the case when everyone makes an *equal sacrifice*, and he therefore proposed a proportional tax rate applying for all income above a sum which would provide “the requisites for life and health” (ibid p.171-2). However, based on the notion that the *marginal utility of income is declining*, that is, a pound lost is worth less for someone who owns a thousand than for someone who owns a hundred, the same principle has also been used to argue that taxation should be progressive (Hoff 1998:44). The most common defense of progressive taxation has however been that taxation should be an *instrument for social justice* (ibid p.108). Unequal treatment of the citizens is justified

by the fact that it reduces the existing inequality in society. Hayek ([1960] 1993:314) has on the other hand argued that progressive taxation violates the principle of *equality before the law* and that it is “no more than an open invitation to discrimination and, what is worse, an invitation to the majority to discriminate against a minority”. Hayek also criticizes progressive taxation for not being based on any real principle, claiming that that there is therefore “no reason why “a little more than before” should not always be represented as just and reasonable” (ibid).

Once a particular thinking on what would be a fair principle for taxation has been established as legitimate within a group of people, this thinking may continue to keep the upper hand through both *institutional* and *psychological* mechanisms. First of all, this kind of values and preferences may be the result of a path dependent employment of *power* (Pierson 2000:259). Lukes (1974) has described power as having three dimensions. The first dimension concerns the power to make decisions, and the second is the power over the agenda, where those in power can stop certain issues from even reaching the point where decisions are made. The third dimension, however, deals with the preferences themselves, and how those in power can manipulate what people think they want. Pierson (2000:259) claims that positive feedback may “transform a situation of relatively balanced conflict, in which one set of actors must openly impose its preferences on another set (“the first face of power”), into one in which power relations become so uneven that anticipated reactions (“the second face of power”) and ideological manipulation (“the third face of power”) make open political conflict unnecessary”. Because a group in power can impose rules that make the employment of power self-reinforcing, initial small differences in power may in this way increase dramatically, but at the same time become less visible (ibid). Studies in psychology have showed that almost any “stable state of affairs tends to become accepted eventually, at least in the sense that alternatives to it no longer readily come to mind” (Kahneman et al 1986:730-731). Hence the result may be an apparent absence of conflict and that the issue becomes depoliticized (Pierson 1993:609-10).

When first introduced, progressive income taxes were described as “class taxes”. Although they started as small taxes paid only by the very richest individuals, the principle was “so divisive that at some points it threatened to split apart the political system” (Steinmo 1994:10). The extremely steep progressive income taxes that were kept in place in the West after the Second World War could be seen as the result of a victory of the low earners in this power struggle. However, the issue seemed to quickly lose its controversy. Though the top marginal rates were cut in most Western countries starting from the beginning of the eighties, the basic principle that high earners should pay a larger share of their income has almost not been open for discussion, not even within the parties of the Right. This could indicate that the judgment of the fairness of the policy has followed a process of path dependence. Though they at first opposed it vigorously, the high earners first came to realize that opposition was useless. As time has gone by it might seem like many of them have also been socialized into accepting that progressive taxation is a “fair” principle and that the system is acceptable to their values.

Such a view would however take as a given that the current systems of progressive taxation indeed serves to redistribute from the “rich” to the “poor”. However, not all income is taxed progressively. Capital income, which constitutes the majority of the income of the richest individuals, has in Norway, as in several other countries, been taxed at a flat rate, considerably lower than the top rate on salaries. The multitude of tax exemptions are also generally thought to benefit mostly those with the highest income, as they have the resources to effectively exploit them. It is thus people with high labor income that carry most of the burden of the progressive taxes. An alternative view would therefore be that the wealthy instead of accepting the “defeat” of progressive taxation, have managed to find a way to escape the taxes. While leaving the impression of a heavily redistributing tax system, the tax burden has been shifted over to the middle class. Indeed, Barth et al. (2003:13) has argued that the whole Scandinavian model is based on an implicit coalition between parts of the working class and the capital owners, who together have been “exploiting” the

middleclass. In this view, it would thus be the middle class who has been socialized into believing that the current tax system is fair.

The path dependent nature of the basic understandings on fairness is further strengthened by the party system. Cognitive psychology has showed that information confirming an individual's beliefs tends to be more easily integrated, while those opposing those beliefs get filtered out (Pierson 2000:260). At a group level, social understandings are shared in ways that create network effects and adaptive expectations, and the result is that "communities of discourse" often share and reproduce a similar ideology (ibid). I will argue that this effect is further aggravated in a political party by the fact that, while normally tolerated, people who think differently seldom make it to the top. On the contrary, the best way to make a career within a political party is normally to *never* say anything that breaks too much with the party's established understanding of the world. Once a party has established a clear view of what a fair tax system should look like, it might therefore be extremely difficult to change it.

The development of parties is furthermore itself subject to path dependence. As Lipset and Rokkan (1967) have showed, parties created at critical historical junctures and for specific purposes, have tended to persist. New parties on the other hand, face considerable start-up costs, and therefore seldom make it to the stage where they gain representation in the parliament. In addition to making it difficult for new understandings of fairness to gain support within an *existing* party, path dependence mechanisms therefore may also stop new parties which represent alternative ideas from emerging.

Finally, path dependence can influence the judgment of the fairness of a proposal through the *complexity* of an issue. The progressive tax systems that have been developed in most Western countries are so complicated that few ordinary citizens, or indeed politicians, would claim to fully understand their own tax system. Judging the fairness of such a system is thus not necessarily an easy task. Psychological research on "judgment by heuristic" shows however that people who are asked a difficult

question often come up with an answer by *substituting* it with a question to which the answer comes more readily to mind (Kahneman 2002:466). It has also been demonstrated that *changes* are relatively more accessible than absolute values (ibid p.481). When asked whether one finds a proposal for a new tax system more or less fair than the current system, we would therefore expect that many will choose to answer whether they find the *changes* between the current and the new system fair. The existing system is however used as a reference for judgments of fairness “*because it is normal, not necessarily because it is just*” (Kahneman et al 1986:730). Because the subject to most people is so complex, the weaknesses that the *current* tax system may have in terms of fairness may be left unchallenged.

Public debates on taxes are hence often greatly simplified by reducing them into calculations on “who gets what” in terms of tax cuts or tax increases. Whether or not a tax reform is judged as fair then depends on whether it “gives” more to people of high income than to those with a smaller one or vice versa. The income groups and, more importantly, the types of incomes that political actors or the media choose to compare are however of great importance, as they may have been closely picked in order to support a certain view. For example, whether the “rich” in the comparison is a person with a *salary* of 2 million NOK (something rather rare in Norway) or a person with a *capital income* of the same size (which is much more common) makes a great difference. People’s judgment on the fairness of a proposal may in this way be manipulated.

The decision makers in the policy communities might themselves be judging possible reforms in this way, or they may simply acknowledge the fact that the majority of the population does. In any case, to make sure a reform is seen as “fair” they will often seek to “balance” tax cuts to the highest earners with comparable cuts to those with a lower salary. Since cutting the taxes for the lowest salaries normally means giving almost everyone a tax cut, this means that cutting even a few percentage points on the highest salaries will be very expensive in terms of revenue. Once in place, any extra tax rate on the highest earners may therefore be extremely difficult to remove.

The basic deduction which is normally an essential part of the flat tax proposal would give significant tax cuts to the very lowest earners. However, this deduction would have to be set at a quite high and, in terms of revenue, expensive level if one would wish to secure that nobody would get a tax increase. In any case, no flat tax reform would be possible without giving most tax cuts to some of the highest earners. Opponents of the flat tax would thus be able to present quite unfavorable “who gets what”-calculations. Although the *principle* of having a single tax rate on all income might perhaps have been judged as fair by many, we would expect that these calculations would make large parts of the Norwegian policy communities conclude that such a reform would be unfair.

Estonia at the time of the flat tax reform was on the other hand experiencing a period of transition from occupation, dictatorship and communism to independence, democracy and market economy. For more than 50 years there had been no political struggles between different income groups. People were not free to participate in political discussions and there were, at least in theory, practically no differences in income. The policy communities were in the shaping and had few institutionalized ideas of how things should be organized or what would be “fair”. Parties had just started to emerge and the party system was far from being institutionalized. A progressive tax system had been in place for a couple of years, but because Estonia at the time experienced a period of hyperinflation, we would expect it to be difficult to make calculations on how different income groups would be affected, simply because people’s income was constantly changing.

We would thus expect that:

2) *Socialization into the current system and the uneven distribution of the benefits of the change to a flat tax contributed to the flat tax being seen as unfair in Norway, while the absence of this kind of mechanisms meant that the proposal was accepted as fair in Estonia.*

2.2.2 Technical and political feasibility

The second survival criterion that the proposal needs to fulfill in order to be seriously considered is that the proposal has to be seen as *technically and politically feasible* to actually introduce. Implementation difficulties may make the road from theory to practice difficult, and proposals which would entail fewer such problems stand a better chance of survival (Zahariadis 2003:8). A proposal may entail *technical* problems, meaning that elements of the proposal are difficult or impossible to actually implement in real life. It may however also involve *political* problems, meaning that a proposal or elements of a proposal may be politically difficult to carry out. If the political difficulties are great enough, it may mean that even if decision makers *in principle* agree with the proposal and find it acceptable to their values, they may decide that it is not worth the political costs it would entail.

When it comes to introducing a flat tax, the great strength of the proposal is its simplicity. As mentioned in the previous chapter, the progressive tax systems of the West have become extremely complex and hard to understand. Those with enough resources have the opportunity to exploit loopholes, and enforcing the tax law therefore demands a lot from the tax administration. A flat tax would mean a simpler tax law that would be easy to understand and easier to enforce. In this sense, if one chooses a system “from scratch”, the flat tax proposal fulfills the criteria of *technical feasibility* to a much larger extent than a progressive tax. But even in a situation where there is a functioning progressive tax system, there are no obvious technical problems involved in introducing a flat tax. Reducing the number of tax rates to one is pretty straightforward, once the decision has been taken.

When we turn to the *political feasibility*, on the other hand, obstacles to change through path dependence mechanisms appear once again. A central part of the flat tax proposal is, as we have seen, that all the existing tax exemptions are supposed to be removed and replaced with one basic allowance. Though practically unproblematic, this may be extremely difficult politically. A powerful source of path dependence is the fact that public policies once adopted may create incentives that encourage

individuals to undertake certain kinds of actions (Pierson 1993:608). These activities may be to develop certain skills or to undertake certain kinds of investments. Once individuals have made this kind of commitments in response to a governmental policy, the disruption caused by changes in policy is greatly increased (Pierson 2000:259). Proposals that at one point might have been regarded as equally possible alternatives as the one that was chosen may suddenly entail significant political costs. The more commitments that have been made in response to the policy, the more the attractiveness of continuing the existing policy will increase compared to hypothetical alternatives. The policy chosen at one specific time may thus appear to be “locked in”.

The difficulty of removing benefits once they have been institutionalized is aggravated by the asymmetry in the way voters react to potential losses and gains. Experiments in cognitive psychology have shown that individuals have a “negativity bias” when it comes to risk (Kahneman 2003:1456). This means that people “will take more chances – seeking conflict and accepting the possibility of even greater losses – to prevent any worsening of their current position” (Pierson 1996:146). As the reference point is normally status quo, alternatives are “evaluated as advantages or disadvantages relative to the current situation, and the disadvantages loom larger than their advantages” (Kahneman 2003:1457-8). In theory one may think that a proposal to have one benefit reduced and another benefit increased with the exact same amount would be acceptable to most people. In reality however, such a proposition might in fact meet strong resistance. Individuals experiencing losses are furthermore shown to be more likely to *remember* this in elections than those who gained (Pierson 1996:145-6). A *revenue neutral* reform is in other words not the same as a *politically neutral* reform (Rose and Karran 1987:14).

Most of the tax exemptions in the progressive tax systems were introduced with the explicit purpose of affecting where to invest, when to invest and how much to invest, and people have made important commitments accordingly. The tax break for interest payments was for example introduced in order to stimulate home construction and

investments in real capital (Tranøy 2000:56). Homeowners have ever since been able to invest in their homes knowing that they will get back part of the expenses from paying back their loans through lower taxes. Another example is the tax deduction on travel expenses for people living far away from their workplace, which is the result of a political goal to maintain the population in rural areas. People have then been able to count on the possibility to deduct the travel expenses resulting from buying a house far from where they work. Buying a house is for most people the most important investment they will ever make. Changing the conditions that they depended on as they made their calculations on what they might afford would seem extremely unfair to most people. Any such proposal would therefore most likely be met with strong resistance.

Building on the work by Kahneman, Tranøy (2000) has argued that the fact that the electorate values the maintaining of current, certain and tangible goods higher than achieving new goods, can explain why it proved so difficult to reduce the tax deductions on interest rate charges in the run up to the Norwegian banking crisis in the beginning of the nineties. If he is right, any attempt to replace a progressive tax system and a multitude of tax deductions with a flat tax with only one base deduction would encounter the same kind of problems. That is, we would expect that even if one significantly cuts people's income taxes, this would do little to ease the strong opposition towards removing popular tax deductions, e.g. the deductions on interest rates.

One option would of course be to introduce the flat tax without removing the most popular existing tax exemptions (see my discussion in 1.1 on whether it would still fall in under the definition "flat tax"). In order not to create too big problems with the budgetary implications, the subject of the next subchapter, this would however necessitate setting the rate significantly higher. A high rate would on the other hand mean that certain low income groups would experience tax increases compared to the current system. This could weaken or completely undermine the alleged positive effects of the flat tax on economical efficiency. More importantly, increasing the tax

of low income groups would make it even harder for the proposal to survive the value acceptability criterion discussed in the preceding subchapter. Leaving the exemptions would also in itself make the proposal less fair, in the sense that the high earners who benefit the most from the exemptions would keep these at the same time as they have their marginal tax rates cut.

In Estonia on the other hand, the existing progressive tax system had been in place for only a short while. Although a new tax reform would not start literally from scratch, the technical problems of introducing the progressive tax system had still not been completely overcome. We would thus expect that the fact that a flat tax would be simple and include less technical difficulties would significantly strengthen the case for the proposal. The short duration of the progressive system also meant that fewer Estonians had made important commitments dependent on the deductions. We would thus expect that the decision makers perceived the political costs of removing the exemptions as small.

We would expect that:

3) *The greater technical feasibility of the flat tax was an important argument in favor of the proposal in both Estonia and Norway. The political problems of removing existing tax exemptions constituted a more important barrier to the introduction of a flat tax in Norway than in Estonia.*

2.2.3 Budgetary implications

The third survival criterion is that the decision makers need to be convinced that the *budgetary cost* of the proposal is acceptable. If the costs of adopting the idea are higher than what the decision makers are willing to prioritize, the idea will be dropped, and less costly alternatives will be chosen (Zahariadis 2003:8). In the complex world of politics it may however be very difficult to determine the exact effects of specific policies (Pierson 2000:260). In our case, predicting the costs of introducing a flat tax may not be as straightforward as it might seem.

As mentioned in chapter 1.1 the advocates of a flat tax claim that it will lead to people wanting to work more, and that the subsequent economic growth will give an increase in tax revenue. The simplicity of the system is also supposed to lead to a reduction in tax evasion and a less expensive tax bureaucracy. Whether or not these effects are indeed real is however a question of quite some controversy among economists, and determining the eventual size of the effects is even trickier.

This kind of uncertainty may be a powerful source of inertia and path dependence. Politicians in power are commonly held to be risk-averse (Rose and Karran 1987:7). If they do not know the exact consequences of change, they might be content with leaving the system as it was, rather than being blamed for failed attempts at improvements. Bureaucrats in the tax administration will also generally prefer known taxes that can be administered by established routines (Rose and Karran 1987:6-7). These routines can be so well established that it leads to the tax administrators being too skeptical about the difficulties of implementing new taxes, “thus encouraging politicians to be even more averse to innovation in taxation” (ibid p.53).

Furthermore, not even the most optimistic proponents of a flat tax would expect all the alleged positive consequences to appear instantly. The claim is rather that in the long run, a flat tax system would be able to collect more revenue than progressive taxation. However, politicians generally have a short time horizon. That is, they have a tendency to be more interested in the short term than in the long term consequences of their actions (Pierson 2000:261). In elections, the decisions of voters are most likely to be taken based on the result of the government’s policies in the short run. Thus politicians will generally “pay attention to long-term consequences only when these become politically salient or when they have little reason to fear short-term electoral retribution” (ibid). Even if the positive long-term consequences of a flat tax could be ensured with some kind of certainty, the promise of increased revenue in some years will thus be of little help to governments concerned with the balance on the next year’s budget, or even more importantly, the budget preceding the next general elections. Most politicians may also find it less than appealing to force

through reforms that are unpopular now, but that will give great advantages some years in the future, as the government by then may have lost the elections, leaving a new government to reap the benefits.

We would thus expect that the risks involved in implementing a flat tax was an important argument against such a reform in Norway. Furthermore, the studies on the flat tax have mostly emphasized that eventual positive results of the proposal on revenue would come in the form of long-term growth, while no positive effects are expected in the short-term. We would therefore expect Norwegian politicians to be unwilling to suffer the short-term political costs in order to achieve these results.

In Estonia the weak administrative capacity of the bureaucracy and the special circumstances of an economy in transition meant that calculations of the next year's revenue would in any case be uncertain. We would thus expect the fear of taking a risk to be smaller. Estonia also experienced extremely serious problems with tax evasion. We could therefore expect that the decision makers had a reasonable hope of a quicker and more certain pay-back in terms of increased tax compliance.

We would thus expect that:

4) *The cut in revenue necessary to introduce a flat tax and the uncertainty surrounding how big the cut would have to be, was an important barrier against the proposal in Norway, but less so in Estonia.*

2.3 The Political Stream

The political stream consists according to Kingdon (1984:21) of such factors as swings of the national mood, administrative or legislative turnovers and interest group pressure campaigns. The term "national mood" describes the notion that a large number of people in the country are thinking along certain common lines and that this way of thinking changes from time to time. National moods such as a "swing to the right" or a "swing to the left" may have important impacts on agendas and policy

outcomes (ibid p.153). Politicians do their best to read changes in public opinion and may adapt their stances to what they sense is popular at the time. In an election year, changes in the national moods have a more direct influence through deciding the government and parliamentary majority of the next election period. A change in government hence creates new opportunities for some proposals, while burying others. Finally, the degree of interest group pressure may indicate to the decision makers the political cost or reward of pushing through a certain proposal. If the costs are too great, the decision makers may decide that it is not worth it. Organized interest groups supporting existing benefits may in this way be a powerful source of governmental inertia. (Kingdon 1984:153-162)

Advocates of the idea claim that it is possible to introduce the flat tax without reducing the net income to the state. However, in order to secure the support of the public with an acceptable combination of a big enough minimum deduction and low enough tax rate, it may be necessary to give tax cuts that would cut the overall revenue. It would therefore be natural to assume that a national mood in favor of tax cuts would make such a reform easier. In most western countries, the parties of the political Left have traditionally, out of concern with the question of equity, been more in favor of progressive taxes, while parties of the political Right, out of a concern with efficiency, have been adopting more regressive taxes (Peters 1991:9). In terms of election results, we would thus expect that the more rightist the resulting government, the more likely it would be that it would consider introducing the flat tax. Finally, we would expect that the strength of organized interest groups affected by a tax reform would influence possibilities of getting through the changes. In particular, we would expect that strong influence groups could aggravate the difficulties that a proposal would experience in fulfilling the *political feasibility* criterion in the proposal stream, while a more weakly organized civil society would make it more politically feasible to push through the less popular parts of the reform.

We would thus expect that:

5) *Estonia experienced a mood more positive to tax cuts, had a more clearly Right-wing government and had less influential interest groups than what was the case in Norway.*

2.4 Policy entrepreneurs

“Policy entrepreneurs” are the advocates of the different solutions appearing from the policy stream, and they may be found in and out of government, in elected or appointed positions, in interest groups or in research organizations. Common to all of them however is “their willingness to invest their resources – time, energy, reputation, and sometimes money – in the hope of a future return” (Kingdon 1984:129). An important advantage of the Multiple Stream model is therefore that the role of the policy entrepreneur opens for explanations including agency and the importance of important historical persons. Although many processes develop outside the control of any single individual, policy entrepreneurs can take advantage of the situations and have a crucial part in joining the three streams. Like surfers, they “don’t control the waves, but they can ride them” (Kingdon 1994:221). Strong actors can anticipate events and use them for their purpose. They may push their concern about a certain problem, they push their “pet proposals”, and they actively try to couple the three streams together. The chances of an idea being adopted is thus significantly enhanced by the presence of skilful entrepreneurs, and dampened if no such person appears (Kingdon 1984:215).

Kingdon claims that the position of the policy entrepreneur is “nearly irrelevant” (ibid p.188). This may be true when the object of the study is how an issue is brought to the agenda, and maybe also to a larger extent in the American political system of checks and balances. In a study of whether a particular policy is *adopted* and when the cases in question are parliamentary democracies, one would however expect it to be of great importance what political actor first brought the proposal to the agenda. Once on the agenda, the extent to which the actor has the power to bring the proposal all the way through to adoption will vary greatly. Whether the idea is first adopted by

intellectuals, journalists, an interest group, the bureaucracy, politicians in power or members of the opposition will thus have important consequences for the future process. When the proposal in question is such a radical move as to reform the whole tax system, we would in fact expect that it to be almost impossible for the idea to be adopted without the backing of key members of the government.

In our case, we would thus expect that:

6) *The actors who brought the proposal of a flat tax to the agenda in Estonia were in a more central and powerful position than those promoting it in Norway.*

2.5 Policy Windows

“Policy windows” are special opportunities for policy entrepreneurs to push their pet proposals or conceptions of problems, and it is in these situations that a coupling of the three streams is most likely to occur (Kingdon 1984:204). The policy window may, according to Kingdon, “open” either in the problem stream or in the political stream⁴. “Problem windows” open because a new problem catches the attention of the key decision makers. When a problem is pressing, decision makers look to the policy stream for solutions. “Political windows” on the other hand open because of a change in the political stream. A new government taking office after an election looks for proposals that fit their program. All three streams must however be coupled together: solutions to the pressing problems must be politically acceptable, and the new proposals adopted as a result of a political event need to be attached to a problem. As the windows normally don’t stay open for very long, policy entrepreneurs need to act quickly to couple the streams before the window closes. The ability of the entrepreneurs to estimate whether a window is or will be open, might thus be of great importance (Kingdon 1984:173-187)

⁴ Because of its importance to whether or not a reform is possible, I choose however to discuss the concept in a separate subchapter

Building on Kingdon's concept of policy windows, Keeler (1993:436) discerns between "micro-windows" that are either brought about by undramatic political events (like a normal election) or by problems of a limited scope (like a plane crash), and "macro-windows" caused by more wide-ranging developments on the political and social scene. Through a comparative study of governments across countries that have achieved substantial reforms, he then shows that the size of the window for reform is "determined principally by the *size of mandate* that the government enjoys and the *severity of crisis* present during a would-be reform government's election and its first crucial months in office" (ibid p.436, emphasis added).

Landslide electoral victories open "macro-windows" through three different mechanisms. First it makes the government appear authorized by the public, thus reducing political and institutional opposition (the *authorization mechanism*). Second, it gives the government a comfortable majority in the legislature (the *empowerment mechanism*). Finally party activists' expectation after a great election victory may create a pressure that makes undertaking reform unavoidable for their leaders (the *party pressure mechanism*). (ibid p.436-9)

Keeler (1993:440) defines a crisis as a "situation of large-scale public dissatisfaction or even fear stemming from wide-ranging economic problems and/or an unusual degree of social unrest and/or threats to national security". Crises may first of all open policy windows through discrediting the incumbent leaders and their ideas and thereby serving to give the opposition unusually impressive mandates (the *crisis-mandate mechanism*). Second, a sense of urgency may create the assumption that serious problems will get worse if nothing is done (the *urgency mechanism*). And thirdly, social mobilization may create fear that inaction may endanger lives and property or even result in a revolution (the *fear mechanism*). (ibid p.440-2)

I will however argue that a fourth mechanism may be just as important as the preceding three, namely what I chose to call the *limited attention mechanism*. During a time of great crisis many different issues may demand the attention of policy makers, media and the general public at the same time. Policy entrepreneurs that are

aware of this fact may take advantage of such situations to pass potentially unpopular proposals unnoticed. When the media and the general public are faced with many issues that require their attention at the same time, proposals in more complex policy areas, that are more demanding to understand, may be particularly “invisible”, as the media is likely to focus on the issues most easily understandable to the public. If the number of policy areas in a state of crisis is high enough, the limited attention mechanism may even affect the politicians themselves, as they will hardly have the time and energy to follow what is going on in all the different areas.

Changing the whole system of taxation according to a theory that has never been tried before in Europe (in the case of Estonia), or at least not in Western Europe (in the case of Norway), is a reform of considerable magnitude. It would therefore not be unnatural to assume that a government would need a “macro-window” to be able to pull it off. In Norway, we would expect that the change of government in 2001 led to a “political window”, but as this was not the result of a landslide election victory and there was no crisis situation at the time, we would not expect it to be very large. In Estonia, on the other hand, we would expect that the crisis that the country went through at the time of the reform opened a “macro-window”. The seriousness of the crisis in almost all sectors and the complexity of tax politics lead us to expect that the limited attention mechanism was an important cause of the great size of the policy window. We would also expect that the policy entrepreneurs promoting the proposal in Estonia were aware of the existence of such a rare “macro-window” and that they took advantage of it to couple the flat tax proposal to the two other streams.

We would thus expect that:

7) *Estonia experienced a larger policy window than what was the case in Norway.*

3. Estonia

3.1 Background

3.1.1 Estonia before the regaining of independence

Estonia was occupied and integrated into the Soviet Union in 1939, and the economy of the country was transformed into the centralized planning system of the Communist state. Agriculture was collectivized, private ownership of farms was abolished and the state controlled nearly all industrial activity (Dietz and Grøgaard 1996:228). The centrally planned economy of the Soviet Union was designed to integrate the republics into a unitary Soviet State and counteract possible attempts of achieving more sovereignty (Smith 2001:113). During the occupation, Estonia had however on several occasions “acted as an economic laboratory for the Soviet Union” (Lauristin and Vihalemm 1997:76). Experiments of using market economy elements in the planned economy were tested in Estonia, and inspired many of the changes that were later adopted in the other Soviet republics (Laar 2002b:45; Van Arkadie and Karlsson 1992:103).

Partly because of this, Estonia had the highest living standard in the Soviet Union (Word Bank 1993, quoted in Laar 2002b:51). The Estonians, however, compared themselves with their Finnish neighbors, whose television a large part of the population had direct access to. While Finland and Estonia had been at more or less the same economic level before the war, it was now obvious to them that they had been left far behind (Laar 2002b:58). The Estonians thus asked themselves, “if Finland had succeeded in achieving such results, why not Estonia?” (ibid p.73)

When Gorbachev’s policies of glasnost and perestroika gave further openings to experiment with economical reform, Estonia made good use of the opportunity to further liberalize their economic system. In the struggle towards more political

autonomy, economic issues played an important part, and Estonian nationalists made explicit demands for further economic autonomy (Panagiotou 2001:272). According to Laar (2002b:89) the preparations for economic reform went parallel with the independence demands, partly because “to achieve public support for Estonian independence it was necessary to show that Estonia could manage on its own”. Many experts had indeed predicted that the small Baltic republics would find themselves in “an economic swamp” if they cut themselves off from the Soviet economy (Smith 2001:114).

Disappointment with Soviet reluctance to seriously address the issue of relations between the centre and the republics prompted leading Estonian economists and public figures to initiate work on an Estonian reform program, “with the object of transferring as much economic authority as possible to the republic” (Van Arkadie and Karlsson 1992:104). One of the suggestions in the plan that was presented in September 1987, was that Estonia should manage its own tax and budget system, and only make a lump sum contribution to the central budget (Panagiotou 2001:272). However, although public support eventually forced the government to accept most of the ideas of the proposal, (Van Arkadie and Karlsson 1992:105), the wish to establish so-called one-channel relations, relations between the two budgets only, was not achieved in full, and many enterprises continued the direct communication with the Soviet Union budget (Tang and Nilgo 1994:5).

A foundation for a broader reform of the economy was created in November 1988 when the Estonian Supreme Council declared the sovereignty of Estonian laws. By prohibiting the enforcement of Soviet Union laws in conflict with those of the republic, it started a process of elaborating new laws for Estonia (Tang and Nilgo 1994:5). However the Estonian leaders soon came to the conclusion that further economic autonomy would be impossible without complete political independence (Van Arkadie and Karlsson 1992:108). On 20 March 1990 the Estonian Supreme Council declared that the Soviet Union state power in Estonia was unlawful, and it proclaimed a transition period for the re-establishment of the independent Republic of

Estonia (Tang and Nilgo 1994:6). Full independence was declared and regained on August 20th 1991.

3.1.2 The tax system before the flat tax reform

Because of the central planning and state control of the economy, the role of the tax system was limited in the Eastern European countries under Communism (Tanzi 2005:xvi). Income taxes generally accounted for a very small share of the total revenue. There were few codified tax laws as taxes were generally collected on the basis of negotiations between the governments and the enterprises, and because there were few taxpayers and a monobank processed the payments, there was little need for tax administration (Gandullia 2005:5). Most people had no contact with the tax authorities and didn't even know how much they were paying in taxes (Profeta 2005:65). Perhaps surprisingly, bearing in mind that progressive taxation was an important demand in the Communist Manifesto (Marx and Engels 1848), taxes in communist Eastern Europe were generally not progressive (Gandullia 2005:11).

As mentioned before, the budget of the Estonian Soviet Socialist Republic was closely connected to that of the Soviet Union. The payments from the profit of the all-Union enterprises located in Estonia and parts of the turnover tax and personal income tax were revenues of the Soviet Union budget, and the Estonian budget had to be validated by the Supreme Soviet (Tang and Nilgo 1994:3). The main state income was the turnover tax. The turnover tax was “a sum of money that as if by chance formed the difference between the commodity price and the wholesale price of the enterprise” (ibid p.4). The payments from the profits of the state enterprises were “as a rule not regulated and happened practically at the discretion of the state government bodies” (ibid). The taxes were neither stable nor equal to all taxpayers, and several deductions were given to enterprises to help the strong ones to invest and to let the weak ones continue their ineffective activities (Taaler 1994:4).

While the tax systems of the West are generally thought to be the results of compromises between the desirability of equity and the need for efficiency, the tax

systems of the Communist countries were designed for neither. Although there has been a lot of discussion between the advocates of “big bang” reform and those favoring a more gradualist approach to the transition of the former communist countries (Roland 2002:1), few would disagree with the claim that “the tax system inherited by the former transition countries was not generally suitable for gradual reform” (Trasberg 2005:96). On the contrary, “completely new tax-systems were needed” (Gandullia 2005:5).

In 1990, the first step towards a new tax system was taken with the switch to a one-channel system which required the enterprises to pay taxes only to Estonia (Van Arkadie and Karlsson 1992:166). The taxes remained however more or less the same until the 1991 tax reform which laid the basis for a western type of tax system beginning from January 1991 (Taaler 1994:4). The new tax system introduced indirect taxation in the form of a value added tax, direct taxes including corporate tax and personal income tax, land and natural resource taxes, social tax in the form of a payroll tax and environmental fees on environmental damaging activities (Van Arkadie and Karlsson 1992:166).

From January 1991 the VAT was set to 10 %, while the Personal Income Tax had marginal rates of 16 % up to 4800 rubles, 24 % for incomes between 4801 and 12 000 rubles, and a rate of 33 % for incomes above that (Van Arkadie and Karlsson 1992:167). In order to close a mounting budget deficit that could destabilize the new Estonian currency, the Committee of Currency Reform introduced an additional 50% tax bracket and doubled the VAT by a decree on 19.June 1992, the day before the currency was to be introduced. The corporate tax was originally also progressive with a tax of 15% for net profits up to 500 000 rubles, 23% for profits between 500 000 and 1 000 000 and 30 % above that (ibid p.167). From July 1992 it was however changed into a flat 35% rate. The Social Tax was set to 20% for employers and “persons receiving wages and salaries outside the relationship with an employer” (Taaler 1994:11), plus an additional Health Insurance Tax of 13 %. From September 1993 it was simplified into a unitary social tax of 33% (ibid p.13).

The reform took place in the middle of a deepening recession with a negative growth and the tax basis was therefore steadily decreasing (ibid p.5). The stated goal was a system with a tax burden of 30 per cent of national income (Van Arkadie and Karlsson 1992:169), that is, more or less the same level as the tax revenue and non-tax revenues had amounted to in the years preceding the reform. The tax burden increased however, and in 1993 it amounted to 37,7%, or nearly 40% if the non-tax revenues are taken into account (Taaler 1994:5).

Madis Üürike (2006 [interview]), the Finance minister during the first year of the Laar government who also functioned as an economical advisor to the government before the independence, says the tax law of 1991 was “an embryo of a tax system”. According to Üürike (ibid), it was a “quite strange system that did not work very well”. The main problem was quite simply that “taxes did not come in” (ibid). Every month the ministry received statistics of major tax arrears, and the biggest sinners were often the state owned companies. The new tax burden was unaccustomed to both employers and individuals. Many enterprises were used to very low taxes that had been set individually and feared bankruptcy if they followed the law. Moreover, because of the general lack of knowledge of the workings of the tax system, enterprises often missed the legal opportunities to reduce their taxable income and used criminal double-booking instead. (Tang and Nilgo 1994:7-10)

3.1.3 The 1992 elections and the Laar 1 government

The first free elections in Estonian after the return to independence were held on September 20th 1992. According to Arter (1996:200) the parties “largely failed to differentiate themselves by projecting clear electoral alternatives” but rather “clustered around the national question and deployed a resonant but essentially passé nationalist rhetoric.” It was clear that the preferences of both the majority of the

parties and the electorate were firmly to the right⁵. Indeed, all the major parties claimed to be either rightist, centrist or right-centrist – nobody wanted to be called leftist (Lagerspetz and Vogt 1998:72). As all the parties agreed on the need for democratic reform and the introduction of a market economy, the campaign focused mainly on the candidates' relations to the old regime. The voters thought along "personal" lines rather than "issue" lines (Vihalemm et al. 1997:205), and the main cleavage was between the "old guard" and the "young professionals" (Lagerspetz and Vogt 1998:71). The party programs were "largely unconvincing" and "not widely read" (Arter 1996:207). The media contributed to this, as they did little to comment on what the parties stood for and what they said during the election campaign, and even made it difficult for leading politicians to publish newspaper pieces presenting party policy (ibid p.201).

"In 1992 there was a battle between new forces and old forces, former communists vs. anti-communists, not so much tax systems and things like that. We were not so concrete, it was about what path to choose and the major lines." (Sinissaar 2006 [interview])

There was therefore not much debate on the details of economic policies preceding the elections. Most of the parties held a general view that taxes should be lowered, but there were no real debates on more concrete proposals for tax reform (Kranich 2006, Jullinen 2006, Sinissaar 2006 [interviews]). According to Laar (2006 [interview]), though he did not try to hide the suggestion to introduce a flat tax, he had a clear understanding that they would never win the elections if they made it a main campaign topic.

⁵ In 1994, when asked to place themselves on a five-point scale from left to right, only 8% of the Estonians answered "left", while 45% answered "right". As a comparison, the results in Sweden the same year were 39% and 30% respectively. (Weibull and Holmberg 1997:224)

“Taxation was not a question before the elections. We were discussing our orientation, western or eastern, and democracy was the main issue. There was quite little discussion of economic issues in detail.” (Jullinen 2006 [interview])

The winner of the election was the Isamaa (Fatherland) coalition which secured 29 of the 101 mandates of the new Parliament, the Riigikogu. The coalition was made up of five parties, the Estonian Christian Democratic Party (EKDE), the Estonian Christian Democratic Union (EKDL), the Conservative People’s Party (EKRE), the Republican Coalition Party (EVKE) and the Estonian Liberal Democratic Party (EDLP). The first four later became a single party, while the Liberal Democrats stayed independent (later becoming what is now called the Reform Party). The parties shared a clear nationalist and anti-Communist orientation along with a support for market-oriented reforms, and won the election using the slogan “Clean the house”, meaning a de-Sovietization of Estonian political and economic life (Lauristin and Vihalemm 1997:106). They took the lead in a coalition government with the ERSP (The Estonian National Independence Party) and the Moderates (Mõõdukad). The ERSP had been the first party to openly oppose the Communist Party in the Soviet Union after it was illegally founded in 1988, and the party’s leading figures were almost all former dissidents (Arter 1996:156). The Moderates, on the other hand, were an electoral alliance of the Social Democrats (ESDP) and the Rural Centre Party (EMKE). The Estonian Social Democratic Party was itself the result of the merger of three groups, the Estonian Democratic Labour Party (EDTE), the Russian Social Democratic Party of Estonia, and the Estonian Social Democratic Independence Party (ESDIP) who had pooled resources to fight off “assaults from both the extreme left and right” (ibid p.173). The party was led by Marju Lauristin, a leading figure in the fight for independence. The Rural Centre Party, led by Ivar Raig, had as its main issues the restoration of private ownership and private farming (ibid p.174).

The composition of a government including both social democratic and rightist parties might seem strange from a Western point of view. The coalition was however mainly bound together by opposition to Edgar Savisaar, the former Prime Minister,

and his Centre Party, who by 1992 had become extremely unpopular among the more nationalist parties. He was criticized for being too lenient towards Moscow and for being undemocratic, and many actually believed he wanted to introduce “a dictatorship and heavy-handed regime in Estonia” (Arter 1996:150, 176-7). Furthermore, the Estonian Social Democrats differed substantially from their Western neighbors. The party leader Lauristin was the former leader of ESDIP, a party who Arter (1996:172) claims “confessed to wholesale ignorance of the fundamental precepts of Western social democracy”. In contrast to many of their fellow social democrats, the Moderates actually drew their greatest electoral support from those on higher incomes and the weakest support from the lowest paid (ibid p.212). Tiit Sinissaar (2006 [interview]) from Isamaa says that though the Moderates were “the most rightist Social Democrats in the world”, the situation at the time was so that you could not really place parties on a left-right scale. It was about “the principles that you believe in – not so much about if you are rightist or socialist” (ibid).

“Left and right was not so important at that time. It was more important for us how to overcome the winter cold. We didn’t have time for long ideological debates with “you are right” and “you are left”. We had just one strong will to get the Estonian state going.” (Hänni 2006 [interview])

Following the slogan from Isamaa’s election campaign of “cleaning the house”, the government that was formed was filled with young people without any communist background (Svege and Daatland 2000:54). Several of the ministers were in their twenties and Mart Laar himself became Europe’s youngest Prime Minister at only 32. Though being young and untainted with a communist past probably made the government more eager to undertake the necessary changes, it also meant that it was completely inexperienced and that many of the new ministers lacked the necessary competence to run the country. Economical education and experience was in particularly short supply, both in the government and in the Parliament. Many of the new leading politicians, including the Prime Minister, were historians, some were journalists, other doctors, but very few had any economical education (Sinissaar 2006

[interview]). Furthermore, those that did have economical education were educated in communist economics with little relevance for the development of the new market economy. The Finance Committee of the Riigikogu was eventually filled with mostly old managers of governmental enterprises who “knew nothing about economics” (Kranich 2006 [interview]).

“Our party didn’t have any competence about finances or economics at all. Our faction therefore never had a leading role in taxation and other economic issues.” (Niitsoo 2006 [interview])

According to Heiki Kranich (2006 [interview]), he was amazed at being asked to be the new Finance Minister just because he “had worked in a bank”. He declined, saying that he was not qualified for it, but realized later that most of the ministers were just more self-confident, not necessarily better qualified⁶. Three days before the new government was to take office, it was decided that the post of Finance Minister would be taken by Madis Üürike, the son of Estonian refugees, who though born in Estonia, had been raised in Sweden. Üürike had more than thirty years of experience on tax questions, from working in the Swedish Tax Administration, teaching at the Uppsala University and working in private business (Üürike 2006 [e-mail]). He faced the difficult task of adapting to a political world far from what he was used to in Sweden. Kranich was for his part asked by the Prime Minister to join the Finance Committee, because “there is no one there who understands finance, and you know something” (Kranich 2006 [interview]).

“None of us knew anything about taxation systems. We had read philosophy books about the principles of economy, but our education was based on the Soviet model of economy. But we were young – we knew everything!” (Kranich 2006 [interview])

Beside the division resulting from the controversial ex-prime minister Savisaar, the main political dividing line between the government and the opposition was the

⁶ A year later he had gathered enough self-confidence to take up the post starting from the end of January 1994.

readiness for decisive economic and political reform (Lauristin and Vihalemm 1997:106). In the transition towards market economy, the former communist countries have been divided between two clear strategies: either changing the economy slowly through partial reforms, thereby minimizing opposition, or undertaking all the necessary reforms as fast as possible in the hope that through a “shock therapy” the economy would quickly start growing and provide enough support to make the reforms irreversible. The young and radical new government were convinced that only “decisive and consistent reform pays off” (ibid p.121). With only a one-vote majority in Parliament, the government had no impressive mandate⁷, but the fact that it was the first democratically elected government after independence nevertheless gave authorization to start the necessary reform. The Laar government went on to choose maximum liberalization on most economic areas: almost no tariffs, no subsidies, no regulated prices, no quotas and, the object of study for this thesis, *no progressive taxation* (ibid p.107).

“What we did was not based on knowledge and research or big debates. We had to move forward very quickly and without deep knowledge. We made our decisions on the basis of instinct. We trusted some people, our friends. Somebody had read a book, heard something or studied something. And we made a choice, this guy we believe, this guy we don’t. We gathered piece by piece like that, and tried to put it together to one system.” (Sinissaar 2006 [interview])

3.2 The flat tax reform

3.2.1 The reform process

According to Mart Laar, prior to his election as Prime Minister, he had read only one book on economics. The book was Milton Friedman’s “Free to choose”, which had

⁷ According to Laar (2002b:210) at one occasion the coalition even needed to bring in a member of parliament to vote the day after she had given birth!

been translated into Estonian and which Laar had read “sometime in 1990-91” (Laar 2006 [interview]). One of the liberal reforms Friedman advocated was the introduction of a flat tax. Laar thought it seemed like a logical idea and raised the issue within the party where the suggestion was supported. And as Laar had been left in charge to write the economical part of the Isamaa coalition’s program, he wrote the flat tax into this (ibid)⁸.

As mentioned before, concrete proposals for economical reforms received little attention in the election campaign preceding the 1992 elections. After winning the elections, however, Isamaa raised the issue of tax reform in the coalition negotiations. All my respondents agree that there were no dramatic discussions at this time, but that to most of them the proposal just seemed to make sense. According to Heiki Kranich (2006 [interview]) “we were the same generation, we thought quite similarly.” In the words of Liia Hänni (2006 [interview]), who as the leader of the Moderate faction signed the Coalition agreement, it “seemed a self-evident solution at the time, it was somehow agreed, and what we agreed on, we did.” And Ivar Raig (2006 [interview]), leader of the Rural Centre Party, says that “there was no strong opposition to the idea.” Others however put it less diplomatically. According to Victor Niitsoo (2006 [interview]) of the ERSP, the Social Democrats in the Moderates “didn’t resist, because they knew nothing about tax policy, they would have resisted if they had known.” None of the Moderates that I interviewed do however admit that this would have been the case.

“We faced this question, as I remember, in a general meeting of the coalition, with all the members of the coalition, and it was informed by the prime minister Mart Laar that we were going to change the tax system. So, then, just do it. It wasn’t so important that we needed to discuss for a long time or to vote about it.” (Jullinen 2006 [interview])

⁸ Other respondents are unsure of who really raised the issue within the Isamaa election coalition. Heiki Kranich claims he had had the idea for a long time before this. None of my respondents do however clearly dispute Laar’s claim that he was the one to raise the proposal first.

It was thus written into the coalition agreement that “the income tax of private citizens should be made proportional” (Eesti Rahvusliku Sõltumatuse Partei, “Isamaa” ja “Mõõdukate” Koalitsioonilepe 1992:7). Again, according to Laar (2006 [interview]), it was the new Prime Minister himself who wrote the actual paragraphs of the coalition agreement. The agreement was signed on October 19th 1992. Nevertheless, Prime Minister Laar hoped to be able to implement the flat tax already in the budget for 1993! However, the government “didn’t manage to do it in the first year because it was hard to manage the budget” (ibid). They had to settle for taking only a first step, removing only the top bracket of 50% (Laar 2002b:180).

According to Finance Minister Madis Üürike (2006 [interview]), some time in the first weeks of 1993, Mart Laar asked him when the new tax system would be ready. Üürike explained to Laar that in the West it was common to use several years to prepare such reforms and that, though they were doing their best to get it done fast, it would still take some more months. He argued that what was important was to have the proposition ready for the beginning of the next year (ibid). But Laar was not satisfied with having to wait for the next budget year before implementing the full reform. On the contrary, he “had hoped to do this it in the middle of the year 1993” (Laar 2006 [interview]). Thus on 25.February, shortly after the conversation had taken place, Laar simply brought up the issue in a government meeting where it was plainly decided that a proposal for a completely new tax system should be presented within two weeks! (Eesti Vabariigi Valitsuse Istungi Protokoll Nr. 15 1993)

”I called home to my wife in Stockholm and told her that “this place is a mad house!” I tried to explain to Mart Laar that you don’t just introduce a new tax system in the middle of the year. It’s not possible. One doesn’t do that!” (Üürike 2006 [interview])

Laar (2006 [interview]) says that the reason why he was able to “be quite tough in government” was that “there was a positive pressure from the Parliament, because the Parliament alliance was quite critical that we hadn’t done this in the first year”. As Üürike had warned, it proved of course impossible to have a finished proposal for a

whole new tax system done within the two-week limit. But the deadline anyway seemed to create a pressure and an understanding that the tax reform was not to be postponed a day longer than what was strictly necessary.

According to Heiki Kranich (2006 [e-mail]) he had already quite soon after the parliamentary elections been asked by Mart Laar to participate in the commission that was set up to prepare the tax reform, “like a personal representative of the Prime Minister and the coalition”. The working group was according to Kranich (2006 [interview]) to a great extent organized around the American tax expert Thomas Hart. Kranich (2006 [e-mail]) says that Hart’s part in the tax reform “cannot be overestimated” and he claims that “without him there would not have been any such reform at all”. Hart had brought with him the “Basic World Tax Code”, a book developed by Harvard University that prescribed what a tax law should include. Large parts of the work were thus reduced to translating the different paragraphs. According to Kranich (ibid) most of the work on the tax law was done outside the official meetings of the commission, when only he, Hart and the translator Marje Einre were in the room⁹. Kranich (2006 [interview]) claims that Hart on several occasions tried to convince him that introducing a flat tax was a bad idea, arguing that one should take more from those that earn more. But Kranich answered that in a flat tax system “they would do that anyway” and Hart eventually gave up (ibid).

The main problems at this stage in the process were according to Üürike (2006 [e-mail]) that those that were supposed to translate the paragraphs from Hart’s book did not know how to apply them, and the fact that Hart did not know the internal Estonian conditions. Üürike (ibid) says he realized that the work on the tax law was not progressing fast enough, and he therefore decided to have a seminar over a weekend to go through the situation. At this seminar, Üürike (ibid) says he understood that if the process continued in the same way, translating all of Hart’s

⁹ Üürike (2006 [e-mail]) disputes this and claims that the whole ministry was responsible for the work on the reform proposal.

paragraphs, the result would be a “mastodon law with solutions to problems that did not exist in Estonia”. He thus saw it as his task to go through the propositions in detail, paragraph by paragraph, and simplify it. Üürike (ibid) had experienced that in Sweden the tax system was changed so often that there was not even time to print new books for students of tax law. The students had to rely on printouts. Üürike did not want this kind of instability and thus saw it as his main responsibility to make sure that the tax law would be simple and stable.

The proposals from the commission and the department were discussed several times in government meetings and meetings of the whole coalition (Üürike 2006 [e-mail]). But when summer came, Laar decided it was better to get the issue past over to Parliament since “it was clear that it would not be necessary to do all of this work at governmental level, because these bureaucrats were not any more clever than the parliamentarians, they were all just as inexperienced” (Laar 2006 [interview]). Since the Parliament would anyway have to pass it, Laar thought they might as well handle the rest of the process. Laar (ibid) says that “it was a very right decision, if we had tried to fix everything at governmental level we would have lost a lot of time and we would probably not have passed it.” The proposition was passed by the government in the parliament’s summer holiday, and it was thus not officially presented to Parliament until it gathered for the new session. According to Laar (2006 [e-mail]), Kranich was however set to work on it from the side of the Parliament already, to speed up the process. Kranich thus continued in another role, as a member of the Finance Committee. According to Kranich (2006 [e-mail]), the discussions with Hart continued, the main difference being that they now took place in the room of the Finance Committee in the Parliament, with the other members of the committee present. Kranich (2006 [e-mail]) says that “new changes were made all the time” and that there were tough discussions both with the opposition, the ministry and with Hart himself. Üürike (2006 [e-mail]) also says that many of the main discussions were brought up again and again, and, according to him, whether the tax should be proportional or progressive was discussed again in a cabinet meeting as late as 7.September 1993.

Unlike what one would normally assume in most established democracies, the rate of the flat tax to be implemented was not the subject of long processes of studies and arguments. According to Kranich (2006 [interview]), he had some years earlier read from a book of “some economist” (he doesn’t remember who) that the limit for when people will try to illegally avoid taxes lies on an income tax of 25 percent. If the taxes are lower than that, people will not think that breaking the law is worth the trouble. So he quite simply put the rate in the new law to 25 percent. But when he introduced the proposal to Prime Minister Laar, Laar told him such a tax rate would not yield enough revenue. It would have to be put higher. Kranich’s responded by saying “OK, Mart, 26 percent, but not more” (ibid). And 26 percent it was¹⁰.

“People were later asking me, why 26 percent why not 30? But I had this in my mind with 25 percent and maybe 26, but not more” (Kranich 2006 [interview])

The coalition agreement said that a flat tax rate should be introduced on salaries. It did not however say anything about the taxation of business. The corporate income tax was then at a 35 percent flat rate. Kranich proposed that the reform should remove the corporate income tax and just tax the profits that are distributed to the owners, with the same flat rate as other income. According to Kranich (2006 [interview]), Laar said it would be impossible to manage the budget without a corporate income tax. But when Kranich insisted that the corporate income tax at least should be at the same level as the ordinary income tax, he got the approval of the government (Laar 2006 [interview])¹¹.

An issue that proved to be controversial was the question of an additional tax-free allowance for children. Following the original proposition of Hall and Rabushka (1995 [1985]), the coalition agreement had stated that such an allowance should be included (Eesti Rahvusliku Sõltumatuse Partei, “Isamaa” ja “Mõõdukate”

¹⁰ Laar (2006 [interview]) confirms Kranich’s version of the story.

¹¹ Kranich got his way in the second Laar government however, and the corporate income tax was abolished in 2000.

Koalitsioonilepe 1992:7). Both Kranich and Finance Minister Üürike opposed this however, claiming it would complicate the tax law too much. According to Üürike (2006 [interview]), he “tried to argue that the tax law should not solve the problems of the social law”, saying that they could “give child benefits through the social law, but we are going to have a simple tax law.” He also pointed to calculations that showed that such allowances would be very expensive. The issue created heated debate in the Government, but in the end, Üürike and Kranich won through. A basic exemption was set to 3600 EEK, but no additional tax-free allowance for children was given (Legal Acts of Estonia 1994:41).

One obstacle that had to be broken in order to introduce the flat tax was the opposition from foreign advisors (Laar 2002a:143). Both the IMF and the World Bank argued strongly against the idea, and some of the advisors from the World Bank even said that such an abrupt cut in the tax level could jeopardize the whole equilibrium of the state finances, leading to a full chaos (ibid). According to Laar (2006 [interview]), to the foreign advisors “the most important thing was the financial stability, and they didn’t believe very much in the theories that if you cut the tax, you’ll get more money”. However, although Estonia had mostly positive experiences from the co-operation with foreign experts from IMF, the World Bank and the EC Phare program (Lauristin and Vihalemm 1997:107), the decision makers had also learned that the advisors might sometimes be wrong. Several of the respondents bring up the fact that the same advisors had strongly warned them against going ahead with the currency reform. The introduction of the Estonian kroon had however proved to be a great success already after the first year. The success strengthened the view among Estonian decision makers that they should “not take for granted some foreign advice or some model that was created in a different time and for a different situation” (Lauristin 2006 [interview]). Thus, according to Laar (2006 [interview]), the international financial institutions “knew already that it was no use to try to pressure us”.

“All foreign countries said about the currency reform that it was impossible, but then we did it. And it was almost the same thing with the tax reform. All the experts warned us not to do it.” (Niitsoo 2006 [interview])

“Foreign advisors had also said, “don’t do the currency reform”. Some had even said “don’t try to be independent”. So we were not very keen to take their advices for granted.” (Lauristin 2006 [interview])

In contrast to what one would expect when important reforms are made in established democracies, organized interest groups had no say in the process preceding the decision to introduce the flat tax. The most important reason for this was that they did not yet exist. Estonia was a young democracy and the civil society was still in the shaping. The kind of interest groups that might otherwise have wanted to defend certain tax exemptions, push for new exceptions for their specific group, or otherwise have an interest in the tax system, were yet to be developed. Liia Hänni (2006 [interview]), who was responsible for the privatization process, says that “it was very hard to find parties with whom to negotiate, but there was no time to wait for these interest groups to form.” Kranich (2006 [interview]) agrees that there were no “serious lobby groups at that time”, and that those that did complain, started first when the law was already introduced. Kranich admits that the process, in addition to being extremely fast, was quite hidden. Though it was “not hidden on purpose”, they “needed quick solutions” and didn’t think that they needed any hearings (ibid). Kranich adds that if somebody had asked for hearings or open discussions, they might very well have been ready to adapt, but that in hindsight he is happy that they didn’t.

“At that time there was no civil society developed on the level of some kind of influence.” (Hänni 2006 [interview])

Estonia had no strong trade union, and concerned about a drop in membership they had distanced themselves from political parties, including perhaps their most natural ally, the Social Democrats (Arter 1996:205). According to Laar (2006 [interview]),

the trade unions were actually more to the right than what constituted the business community of the time. The directors of the biggest companies were still mostly former active communists, who had arrived at their positions through loyalty to the Communist Party. The business community was thus according to Laar clearly against the flat tax proposal, but they had little influence over the policies of the rightist government.

“The government was mostly to the right, then there were the trade unions, and then the directors of big business were mostly to the left.” (Laar 2006 [interview])

Although there was a general mood in favor of tax cuts, according to Laar (2006 [interview]) the flat tax was not popular among the general public. However, again, not many people knew about it before the reform was already introduced. There was almost nothing about the tax reform in the media. The main reason for this was simply that there were so many other things to write about. The economy was still in a situation of crisis, with most people having experienced a drastic fall in their living standards. In the winter of 1991-1992 the prices had gone up rapidly, fuel prices going up by 200 to 300 percent, there was a shortage of food and other goods, and crime was skyrocketing (Lagerspetz and Vogt 1998:59). Russian troops were still in the country, adding to the Estonians' fear that their newly won independence could easily be taken away from them¹². The government's internal problems also attracted attention, as it went through both non-confidence votes and several internal reshufflings. And on October 17th 1993, while the tax proposal was being discussed in Parliament, the country faced local elections. After independence had been achieved and as the living conditions continued to deteriorate, the number of Estonians interested in politics had also fallen drastically (Arter 1996:201). While in January 1990, 90 percent of the population claimed to be interested in politics, only 43 percent answered the same in October 1993 (Vihalemm et al 1997:203).

¹² Lagerspetz and Vogt (1998:77) have argued that this fear made people willing to postpone their demands for better living standards in an effort to cut loose from Russia, and that this is a key factor explaining the radical nature of Estonia's economic reforms.

“The newspapers were more or less silently supportive, which means that they were silent... Estonia was in such a situation that there were many other interesting things for the media to write about. In 1993 we had all possible conflicts that you can only imagine. That might be why such a reform was not very noticed.” (Laar 2006 [interview])

“There were much more interesting things to discuss. How to get rid of Soviet troops, the situation in the agriculture, pensions, social problems etc.” (Niitsoo 2006 [interview])

“I think that in that time the public opinion was not so interested in tax questions. Life was so hard that people were mostly interested in how to survive, how to organize their own lives.” (Hänni 2006 [interview])

The lack of internal opposition towards the proposal in the government coalition may rely on much the same reasons. The country needed to quickly build both the institutions necessary for an independent country, for democracy and for a market economy and faced grave difficulties in almost all political areas. In the choice between making changes to the laws of the Soviet system, building on the laws from the first independence period or simply starting from scratch and making all the laws new, Estonia chose the latter (Sinissaar 2006 [interview]). Although this had its advantages (compared to e.g. Lithuania who chose the first option and Latvia who chose the second), it meant that an enormous amount of laws had to be written in a relatively short time. Both the ministers and the members of Parliament were thus incredibly busy. Several of the respondents say they simply did not have time to involve themselves in the issues outside their own areas of responsibility.

“Everyone had to deal with their own area. In every area, everything was collapsing. So they didn’t have much time to see what was happening in the other areas.” (Laar 2006 [interview])

"I was so overloaded by my own tasks. We debated some questions quite thoroughly, but the rule was that we trusted our partners. It was a government based on trust." (Hänni 2006 [interview])

"We had other problems to discuss, land reform was a huge thing that was on the agenda almost every day, Soviet troops were still in Estonia. More or less everybody agreed on having simple taxes." (Raig 2006 [interview])

"We were worried by Russian troops that were still in Estonia, we didn't even have the laws required by the constitution, so we were writing them. These were more important issues for the Parliament." (Jullinen 2006 [interview])

The proposal was presented to Parliament on 13th September 1993. According to Laar (2006 [interview]), "the opposition was absolutely furious". He adds however that "of course, the opposition was furious about everything". This might not be very far from the truth, as by the following summer there were serious problems within the Centre Party where party veterans complained of Savisaar's "highly confrontational style which effectively amounted in their view to "opposition for its own sake"" (Arter 1996:178). However, according to Laar, also Tiit Vähi of the Coalition Party, who eventually became Prime Minister in 1995, promised that he "would remove the flat tax immediately, in two weeks, when he regained the power" ¹³(Laar 2006 [interview]).

The government thus had to "press it through by force" (Laar 2006 [interview]). As mentioned, the Government coalition had only a very narrow majority of 51 out of 101 representatives in Parliament. However, the proposal also received the support of a somewhat unlikely ally. The Independent Royalist, known mostly for ridiculing other politicians (Svege and Daatland 2000:75), voted in favor of the proposal. Their support is less surprising however considering that, according to Arter (1996:204), the Independent Royalists actually "counted several competent economists among

¹³ When Vähi did take over he did not however make any attempt to change the tax system.

their parliamentary number and contributed in a generally responsible way to the process of policy making”.

When the new Income Tax Act was passed on 8th December 1993, in addition to six of the Royalists’ eight votes (two of them did not vote), it received the backing of one of the Estonian Citizens Union’s four representatives, the Green Party’s one vote, four independent members of Parliament, and one break-away member of the Coalition Party. The government coalition was united behind the proposal, with the exception of one member of the Moderate faction who voted against. (Riigikogu hääletussüsteem 1993) The new law went into force from January 1, 1994 (Legal Acts of Estonia 1994).

3.2.2 The arguments

Value acceptability

In the theory chapter we expected to find that the flat tax would be acceptable to the values of the most important Estonian policy communities. And there seems indeed to have been a general consensus among the coalition partners that a flat tax would simply be fair. The strongest support for the fairness of the flat tax came, not surprisingly, from the most rightist parties of the first Laar government. Kranich (2006 [interview]) argues that “if a man wants to work harder to make a better life for his family and his children and earns more money - why should the government punish him for that?” Tiit Sinissaar (2006 [interview]) argues that “it just seemed just” because one “couldn’t banish those who are successful”. Viktor Niitsoo (2006 [interview]) of ERSP says that it was “simply fair” that everybody would pay the same percentage and that it was thus “not controversial at all”. But also the Social Democrat Lauristin (2006 [interview]) explains that, in contrast to Western Europe where there are “fixed ideas on what is just and what is not just”, the Estonians “had the privilege to take everything with childish eyes, to look at things from the

perspective of what would really work, and what do we want, without listening to voices who said, “oh, but we have never had that””. In her opinion, because of the sizable tax free minimum, the flat tax system “is not less just than progressive systems, maybe even more just”. Lauristin (ibid) even goes so far as to call the Centre Party’s arguments against the flat tax “mythological social arguments”, and claims that their continued opposition “has lost its rational meaning, and is becoming a type of mythological opposition”.

“We didn’t feel that it was a problem with justice.” (Jullinen 2006 [interview])

Several of the respondents say the argument about fairness was made simple by the equality at the time of the reform. Jullinen (2006 [interview]) says that “we didn’t feel that some were poor and some were rich” and Kranich (2006 [interview]) states that “we were all in the low income group at that time”. Victor Niitsoo (2006 [interview]) points out that “those few that were rich, were mostly criminals who didn’t pay taxes anyway, legally rich people were almost non-existent.”

“We had a very poor population, and the differences in income were very small.” (Lauristin 2006 [interview])

According to Madis Üürike (2006 [interview]), there were some advisers within the Finance Ministry who argued that one should have some kind of top level tax for “those that earned millions”, but it was “no big question”. That it was unfair to not tax the highest earners with a higher percentage was however the main argument of the opposition (Laar 2006 [interview]).

“When you start counting, how many rich people we have, how much we could get by progressive taxation, then you discover that in order to get income to the state budget, you need to tax more than just the rich.” (Hänni 2006 [interview])

Technical and political feasibility

As expected in the theory chapter, the greater technical feasibility of the flat tax strengthened the case for the proposal considerably. Indeed, it seems that the

simplicity of the flat tax was the most important argument for most of my respondents. As we have seen, the problem with the tax system implemented in 1991 was simply that the taxes were not being paid. Since the system copied from the West demanded a whole new way of administering taxes than what had been the case in Soviet times, it basically meant that a whole new tax administration would have to be built up from scratch. Estonia thus had no experienced administration that could efficiently fight tax evasion (Laar 2002a:142). In addition, since the Communist system had not relied on income taxes, people and businesses were simply not used to having to pay taxes. This led to both a lack of knowledge of what laws and regulations demanded that they should pay, and a lack of willingness to pay the required share of their income in a time of general economic crises. The argument was that the flat tax would be easy to understand for both tax payers and tax collectors, and that the tax collectors thus could concentrate on how to catch those that were not interested in paying any taxes at all (Laar 2002b:275). According to Lauristin (2006 [interview]), at least from her party's point of view, "there was no ideological debate; it was a debate on effectiveness and pragmatic implementation."

"Flat tax was simple. Everything started from scratch, and to start a new system we needed to make it as simple as possible." (Hänni 2006 [interview])

"At that time our government was very weak, the tax office had no administrative capacity. That's why there was an urgent need to work out something very simple." (Raig 2006 [interview])

The mentality of general distrust of the government inherited from the Soviet times was also a major reason why simple and low taxes were seen as so important. According to Marju Lauristin (2006 [interview]) "the experiences from Soviet times were experiences of evasions; how to counteract the system, how to make a fool out of the government." Heiki Kranich (2006 [interview]) also mentions that "the rules in Soviet times were broken by everybody". In the words of Lauristin (2006 [interview]), the argument was thus that "in a situation where you couldn't rely on conscience and the honest behavior of the taxpayers, you have to take into account

that the system should be simple to control.” Heiki Kranich thought along the same lines in his defense of why the tax rate should be low (and preferably below 25%). In his opinion it was necessary to “follow the morality that exists in society and fit the laws to a level that is possible to fulfill” (Kranich 2006 [interview]). The ERSP had as a main slogan before the elections that they were going to make everyone pay taxes. Though they themselves did not have any concrete solution to how they would make that happen, when introduced to the idea of a flat tax, they also saw it as one way to fulfill this election promise (Niitsoo 2006 [interview]).

Both Laar and Lauristin mention that the wish for simplicity was also influenced by their impressions of the complicated tax system in neighboring countries. Laar (2002a:141) describes how even the Soviet press had been telling the story of how the Swedish tax system made the famous author Astrid Lindgren pay more taxes than she had in income. The Social Democrat Lauristin (2006 [interview]) also brings up Sweden saying that “what we had seen from other countries, like Sweden, is that when the tax system is complicated and with many layers, then there is a lot of work for tax officials, lots of work for the citizens, very complicated tax forms, and massive opportunities for evasions.” She says they “understood that we would not be able to build up this kind of bureaucracy”. Raig (2006 [interview]) and Kranich (2006 [interview]) also mention the consequences of a complicated tax system in terms of a large public administration and extra paper work for the private sector as part of the reason for the wish to keep it simple.

“We used it as a main argument, look at the neighboring countries – their tax systems are just not working.” (Laar 2006 [interview])

A second reason why the simplicity of the flat tax was an important argument was the need for a system adapted to a situation of very high inflation. In political economy, “bracket creep”, the way governments can increase their tax revenue by keeping the brackets stable while inflation slowly makes more people reach the highest rates, is a known concept. However, with normal inflation levels, this usually happens over several years. In Estonia, from the day the progressive tax system had been adopted

in October 1990 to the time of the introduction of the flat tax in December 1993, prices had increased with 6872 percent. However, the brackets for the different rates had only been corrected once, in January 1992 when they were a little more than doubled. (Taaler 1994:14) This meant that virtually the whole working population very quickly reached the highest bracket. In 1992 alone Estonia experienced an inflation rate of 1069 percent, and although it fell sharply with the introduction of the new currency in June the same year, the inflation was still at 85 percent in 1993 (Nørgaard 1996:140).

“A lot of people saw that through inflation they went very quickly to the highest bracket.” (Kranich 2006 [interview])

According to Laar (2006 [interview]), “people were quite angry with the existing tax system because most of the population was pressed to the highest brackets immediately”. The anger over having to pay the highest rate made people even more prone to try to evade the taxes, limiting the effect this would otherwise have had on the state revenue. It was thus “very practically seen that the system was not working” (ibid).

“The question was whether to change the brackets all the time or just to make the tax flat.” (Jullinen 2006 [interview])

The hyperinflation also considerably reduced one of the major political obstacles to the introduction of a flat tax, namely the problem of having to increase the taxes for some medium to low income-groups in order to give tax cuts to those on the highest rates. Since by the end of 1993, virtually the whole working population were paying (or should have been paying, had they declared all their income) the highest rate of 33 percent, setting a flat rate of 26 percent meant that most people received a tax cut.

Both the argument for simplicity due to lack of administrative capacity and the problems connected to hyperinflation led some of the leading politicians to point to the flat tax as a preliminary solution. According to Ivar Raig (2006 [interview]), “we thought that if people would later earn more, then we can come back to this idea of

progressive taxes, but since in the first stage all people were poor and equal from Soviet times, there was no need to make a complicated tax system at that time”. He says that “the Social Democrats thought that probably in the next stage they would change it, because they knew that in Europe that was how it was done” (ibid). When asked by the media ahead of the parliamentary elections in 1995 whether they supported the introduction of a progressive income tax the Moderates thus answered “yes” but that “the implementation is not justified until our income level is similar to that of Europe” (Hommikuleht 1995). Also the leader of the Independent Royalists, Kalle Kulbok, claims that their impression of the flat tax reform at the time was that this would be a good short term solution (Kulbok 2006 [e-mail]).

”We just wanted a simple and clear tax system. That was the main issue. We said that maybe after some 10-15 years we can return to discuss a progressive tax system, but now we should just get started collecting taxes.” (Jullinen 2006 [interview])

When it comes to the political feasibility of the flat tax proposal, the respondents confirm my expectation that the removal of the tax exemptions did not constitute any major problem in Estonia. On the contrary, this part of the flat tax reform, seen as perhaps politically most difficult in western countries, proved not to be controversial at all. According to Laar (2006 [interview]), “there weren’t so many”. Perhaps even more importantly, because of the short duration of the previous law and the public’s law competence on tax matters, Laar (2006 [interview]) claims “nobody had used them.” Though all the respondents agree that removing exemptions was no problem, several of them mention that the issue of exceptions was brought up *after* the flat tax was already introduced. The Rural Centre Party part of the Moderates even had a bill initiated by some of their members that proposed exceptions for farmers, but, as Jullinen (2006 [interview]) puts it, it was “a right-wing dominated coalition, and most of them didn’t want to hear about any exceptions”.

Budgetary implications

The main argument against the flat tax was undoubtedly the fear of the uncertain effects of doing something that had only been thought out in theory. Üürike (2006 [interview]) says that as far as the Finance Ministry knew, the system didn't exist anywhere else in the world, and that this in itself was perhaps the most important argument against the proposal in the Ministry. The opposition also warned strongly against doing something that had never been tried before (Laar 2006 [interview]).

“It wasn't an intellectual discussion, more a fear of doing something no one else had done” (Üürike 2006 [interview])

On the other hand it seems like many of the responsible decision makers truly believed that the flat tax would mean an *increase* in the tax revenue. In addition to believing that the simplicity would reduce tax evasions, there was a strong belief that a flat tax would increase the state's revenue through an increase in the growth of the economy. Under the Soviet socialism people were not used to taking the initiative or assuming risks. Laar (1996:98) therefore claims that people had to be “shaken out of the illusion – common in post-communist countries – that somehow, somebody else was going to come along and solve the problems for them”. To him, the main purpose of introducing the flat tax was thus “supporting the free and productive activity of our people” (ibid). According to Laar (2002b:272), when Estonians who had founded their own companies understood that the tax system punished them for being successful, their enthusiasm had declined considerably. To encourage further growth it was thus necessary to change the tax system to make people see that “hard work was going to be rewarded rather than punished by confiscatory taxation” (Laar 1996:99). Sinissaar (2006 [interview]) also says that to him the most important argument was a flat tax would lead the country out of poverty more quickly.

“We all simply believed that the money that we would get would be more than with the old system.” (Jullinen 2006 [interview])

“The flat tax system helps increase the nation’s wealth more rapidly than other systems. That was the main reason why we made that choice. And it has proved to be a right decision.” (Sinissaar 2006 [interview])

However, even Mart Laar himself was getting seriously worried about whether it would really work when “at one moment” he “really understood that nobody had really done this” (Laar 2006 [interview]). Earlier the same year Estonia had passed a Budget Act that by law made it compulsory to keep the budget balanced (Laar 2002b:181). To accept a deficit in the first year in the hope that the positive effects would manifest themselves in time was thus not an option. Both the IMF and the World Bank had, according to Laar (2006 [interview]), made different prognosis, that all showed that Estonia would have a quite clear deficit. They did not believe that the increases in paid taxes would gather enough to cover the losses. According to Kranich (2006 [interview]), the government relied on estimations from Thomas Hart, who “used some models and adapted them to Estonian conditions”. The prognoses were according to Laar (2006 [interview]) “very highly criticized in Parliament as unrealistic”, and the opposition claimed the lack of revenue would “destroy the economy”.

“Estonia had to stick its neck out and hope that the ideas elaborated and proved by scholars would find verification in reality” (Laar 2002b:272)

But even the most optimistic estimations proved to be wrong: The flat tax gathered a lot more income than anyone had expected. According to Laar (2006 [interview]), this was basically because “people’s income proved to be much higher than what any statistics showed”. The new system had in his opinion been extremely successful in targeting the grey sector. Another important explanation, not necessarily connected to the tax reform, was however that the economy of the country by 1994 had already hit the bottom, and, as Kranich (2006 [interview]) puts it, “it was again time for the Estonian economy to grow”.

3.2.3 The policy entrepreneurs

It seems clear that the most important person behind the flat tax reform was Prime Minister Mart Laar. He was the one who wrote it into his party's program, he made sure that it was included in the coalition agreement, and his impatience in seeing it through was almost naive. Most of my respondents seem to agree on the personal importance of Laar. Heiki Kranich (2006 [interview]) says that it "would have been impossible without the personal part of Mart Laar". Ardo Hansson, a Harvard-educated economist who was a top advisor to the first Estonian governments after independence also says that "as for the flat income tax, that was mostly the then Prime Minister Mart Laar who pushed it through – almost on his own" (City Paper 1998).

However, Kranich's role in the process should not be underestimated. Laar (2006 [interview]) says that "Heiki Kranich was very important when it came to the Parliament level, to really negotiate and get it done in the Parliament." Laar points out that it was Kranich's idea to have the same rate on business, and he confirms Kranich's story of how the rate ended up at 26%. Jullinen (2006 [interview]) also emphasizes the role of Kranich, and that, as Kranich and Laar were quite close at that time, they worked as a team, one promoting the idea in government and the other in Parliament.

"You must be a little bit crazy to do something like this. People say that it seemed impossible to do what Estonia did. But Estonia was a small ship with a very young crew. An experienced captain would know that it is impossible to turn a ship around that quickly. But we didn't know. We just turned it!" (Kranich 2006 [interview])

Laar (2006 [interview]), Kranich (2006 [interview]) and Jullinen (2006 [interview]) also identify Valve Kirsipuu, the chairwoman of the Finance Committee as an important contributor to getting the reform through in Parliament. Kirsipuu was very popular because of her courage to speak out and criticize the authorities at the end of the Soviet times. She and Kranich were "very good friends who trusted each other"

(Kranich 2006 [interview]), and though she was elected to Parliament on the Moderates' list, she later joined forces with Kranich in what became the Reform Party. When it came to the issue of flat taxes, Kranich claims that she just trusted him. She then managed to convince skeptics both in the committee, her own party and in the general public. Kranich, who wasn't as known to the public, says he at times even pushed it as being her idea. (ibid)

"Kirsipuu had some economic background and we took her as an expert. If she didn't have any major arguments against it, then it was OK for the others." (Jullinen 2006 [interview])

Laar's hurry in getting the reform through as fast (or rather faster) than practically possible, seems to have been grounded in a very clear understanding of the rare possibility for radical reform that was open to them. Laar (2006 [interview]) believed that "the most crucial thing in all the reforms was speed, because for every month that you loose, you will not manage to do some of the reforms". The hurry in passing the reforms also made the before mentioned wish for simplicity more important, because of the lack of time for preparations (Laar 2002b:165). Laar knew that the "window of opportunity does not last very long" (ibid p.164). Finance Minister Üürike was thus not the only one who was given a two week or one week deadline to have a proposal ready.

"I sometimes locked-up people into some governmental residence and let them out the next week. But that was the only way. The mistakes that we did were when we didn't pass enough [reforms]." (Laar 2006 [interview])

Both Laar and Kranich claim they did not worry much about whether or not the flat tax would be popular or not. Kranich (2006 [interview]) says that they "didn't think of that at all, it was just the right thing to do." In Laar's (2002b:213) opinion they "were not in power to bring a consensus to Parliament or even, unfortunately, to society, but to use the window of opportunity which was presented to them and to turn Estonia from the East to the West". The belief in shock therapy and speedy reforms meant

anyway that by the time the flat tax was being discussed in Parliament, the government had already introduced a great deal of unpopular reforms. It seemed clear that it would not be the flat tax that would lose the elections for the coalition.

"All the reforms that I did were unpopular. This was just one more. It was not such a terrible thing" (Laar 2006 [interview])

4. Norway

4.1 Background

4.1.1 The 1992 Tax Reform

Up until the mid-1980s the Norwegian tax system was characterized by high formal tax rates, combined with comprehensive deductions and tax credit schemes. The system had a clear aim to allocate investments both to certain businesses and to certain regions (NOU 1999:7:42). The value of the deductions followed the marginal tax and thus greatly reduced the redistributing effect of the progressive rates. The reforms began from 1987 with a reduction in the progressiveness of the income tax. The highest marginal tax rate on “net income” was reduced from 66 percent in 1986 to 40 percent in 1991, and the highest marginal tax on salaries was reduced from 74 percent to 58 percent. (NOU 2003:9:139) The stated goal of the 1992 tax reform was to reduce tax-induced distortions to a minimum. Tax rates were lowered and the tax base was broadened, eliminating many of the deductions. One of the main features of the new system was the division into two different concepts of income: general income and personal income. Capital income was taxed as “general income” with a flat tax of 28 percent, and this rate also applied to companies and corporate tax payers. Labor income and pensions were taxed progressively as “personal income”. This meant that in addition to the 28 percent general tax rate, tax payers had to pay a social security contribution of 7,8 percent, and high salaries were taxed with two additional rates of 9,5 or 13 percent, making the maximum marginal tax rate 48,8 percent. A basic allowance and a number of expenses, including interest payments, were deductible from the general income. The employer’s social security contribution was 14,1 percent. (Finansdepartementet 2006a)

When an owner of a company is actively participating in the business, part of the income will be yields on capital and part of it will be labor income. This can however

not be read from the accounts. The 1992 tax reform thus introduced a “split model” in which a part of the taxable income of self-employed individuals was considered to be capital income and subject to the 28 percent tax, while the rest of the income was treated as personal income from which one had to pay progressive tax rates. The model also applied to income earned by partnerships and limited companies if two-thirds or more of the partnership or company in question was owned by active partners or shareholders. (ibid)

4.1.2 The arrival of the flat tax proposal to the agenda

It did not take long before it was evident that the split model of the 1992-reform had several weaknesses. The model was complicated and inaccurate, and it was relatively simple to make adaptations to have actual returns on labor taxed as capital income. Changes that had been made in order to make the model more lenient had also made it even more complicated and open for evasions. Furthermore, as we will see in the following subchapter, an increase in the gap between the tax on capital and the one on labor made the temptation to try to fool the system even greater. (NOU 2003:9:187)

“The main problem with the split model was the great difference between tax on capital and tax on labor which led people to try to redefine labor income as being capital income. The feeling of injustice among small businesses with active owners was disturbing.” (Steensnæs 2006 [interview])

Different proposals were thus being developed to try to solve the problem of the gap in taxation on capital and wages in a different way, and it was as a part of this effort that the flat tax proposal was first brought to the agenda. In March 1997 Carl I. Hagen, the chairman of the Progress Party, filed a private proposition in the Parliament suggesting that the Government should “appoint a broadly composed tax committee to investigate and assess different systems for and consequences of an

equal and flat income tax” (Dok.nr.8:66 (1996-1997)¹⁴). In the proposition Hagen claimed that the split model was creating great problems for both businesses and the tax administration, and that it represented a great loss for society when highly educated people, both in the private and in the public sector, were fully employed with discussing whether an income resulted from capital or labor. A flat tax on all types of income would in his opinion be a solution to this problem.

Perhaps surprisingly, a broad majority consisting of all the parties except the Socialist Left and the Red Electoral Alliance, supported the suggestion that such a report should be made (Innst.S.nr.257 1996-97). This did not however mean that the proposal to introduce a flat tax was seen as realistic or desirable by the other parties. On the contrary, according to Foss (2006 [interview]) and Steensnæs (2006 [interview]), both members of the Finance Committee at the time, it seems the main intention of the other parties was to get proof that such a system would not be possible. The exception was the one-man party group of the Liberal Party, which had the introduction of a flat tax in their program.

“We wanted to avoid being accused later of not even wanting to consider a flat tax model. But my thought was to have it demonstrated once and for all that this was not a possible path to a fair tax distribution.” (Steensnæs 2006 [interview])

The Bondevik I government consisting of the Christian Democrats, the Center Party and the Liberal Party that came into power the same fall, appointed the Stølen Committee to carry out the report requested by the parliament. However, the Finance Ministry gave the committee the limitation that the suggestions for a new tax system should “not reduce the overall tax revenue” (NOU 1999:7:11). The commission itself decided that the models would not include changes in VAT or in the employers’ contribution (ibid). Furthermore, because of the insecurity involved in estimating the effects on employment and tax income of a flat tax, the committee decided to base

¹⁴ All the direct quotes from Norwegian official documents, books and articles are translated by the author. In describing the tax system I have tried to follow the terms used on the English web pages of the Norwegian Ministry of Finance.

their analysis on “revenue neutral reforms given unchanged adaptations” (ibid p.120). In other words, their models would not count on any positive effects on efficiency or increases in labor supply.

“I didn’t see it as a possible option. But it is often useful to get a report that kills the thought. And it did.” (Foss 2006 [interview])

The committee came up with four alternative models, from which only one implied a single tax rate. However, under the above mentioned conditions and without removing any exemptions, this model implied that the tax rate would have to be set at 38,5 percent, and the committee therefore opposed changing the system in this way (NOU 1999:7:190). A second model included replacing most of the current exemptions with a basic deduction of 78 000 NOK, removing the surtax, but leaving the social security contributions of 7,8 percent as a separate tax only to be paid on salaries. In this model the tax would be set at a more acceptable 30 percent. However, the committee rejected this model also, as they saw “several good reasons to keep several of the current deductions” (ibid). The conclusion of the committee, which by then had re-named itself the “Flatter tax committee”, was a relatively moderate proposal to reduce the surtax to 4,5 percent, increase the tax on general income to 30 percent, increase the personal allowance and remove some exemptions (ibid p.191).

4.1.3 Changes to the income tax before the 2006 reform

After the tax reform of 1992 the main principles of the income taxation stayed relatively stable. The tax on general income was not changed, but the taxes on personal income went through some important changes. Already the year after the reform, the top level in the surtax was raised to 13,7 percent and the employer’s social security contribution was increased with 10 percentage points for incomes above 16 times the “basic amount” (G) of the National Insurance system. In 1999 this extra tax was increased to 12,5 percent while the two surtax rates were replaced with one common rate of 13,5 percent (NOU 2003:9:139). In the budget negotiations in the fall of 1999 however, only months after the Stølen Committee had presented its

report suggesting a *reduction* in the top income tax rates, the Bondevik 1 government agreed to demands from the Social Democrats to introduce a new top rate in the surtax, this time at 19,5 percent (Innst.O. nr.12 (1999-2000)). The gap between tax on capital and labor income was thus further increased. According to Steensnæs (2006 [interview]), this was *not* something that the government wanted, but because it was symbolically important to the Social Democrats, it was “a camel they had to swallow”. Olsen (2006 [interview]) explains the Liberal Party’s acceptance of this by the fact that they were a small party and that they needed to prioritize what they used their influence on, and “this wasn’t so high on the agenda”.

In the spring of 2000 the Bondevik 1 government was replaced with a Social Democratic minority government (Stoltenberg 1). In the budget negotiations the following fall the centrist parties agreed to introduce a temporary tax on dividends of 11 percent. According to the agreement, the tax was supposed to be replaced with a new tax system starting from 2002, when the taxation of labor and capital would be made more equal so that the split model could be abolished (Innst.O.nr. 23 (2000-2001)). During the spring of 2001 it became clear that it would not be possible to have a reform ready within the promised time frame, and it was agreed that the government would only present a white paper on the reform the following fall (Innst.S.nr.152 (2000-2001)). As we will see in the following subchapters, the Stoltenberg government was however replaced by the Bondevik 2 government before such a proposal could be presented.

In 2003, the year before a reform proposal was finally brought to the parliament, the progressiveness of the personal taxation in Norway worked in the following way (illustrated in figure 4.1): the social security contribution for salaries was 7,8 percent. For income under 23 000 the social security contribution did not apply, but incomes above this level were taxed with 25 percent until the tax equaled 7,8 percent of the whole income, that is 33 430 NOK. The marginal tax then fell to 7,8 percent, until the income reached 63 400, which was the sum of the basic tax allowance and a special allowance applicable to labor income. Because this allowance was higher than the

basic tax allowance for employees with a salary of up to 132 500, incomes up to this sum were taxed at a marginal rate of 35,8 percent. The basic tax allowance was set at a rate of 24 percent of the salary until the salary reached 190 400, as a result of an upper limit in the basic tax allowance. This meant that the marginal tax for income up to this sum fell to 29,1 percent. For incomes above 190 400 the marginal tax was again 35,8 percent. The surtax raised the marginal rate to 49,3 percent for incomes above 340 700, and to 55,3 percent for incomes above 872 000. (NOU 2003:9:34-38)

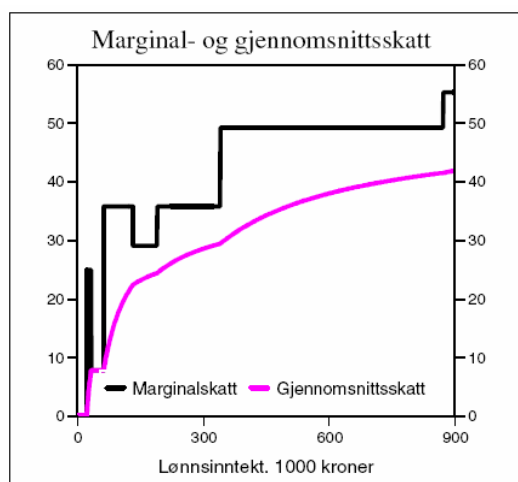


Figure 4.1 Marginal and average tax on salaries according to income in 1000 NOK. Class 1 2003-rules.

Source: NOU 2003:9

4.1.4 The 2001 elections and the Bondevik 2 government

The Parliament elections of 2001 turned out to be a disaster for the Stoltenberg government. In their worst elections since 1924, the Social Democrats achieved only 24,3 percent of the votes, down from 35 percent four years earlier. The great winners were the Conservatives, going from 14,2 to 21,2 percent, and the Socialist Left who doubled their share of the votes to 12,5 percent. The winners of the 1997 elections, the Progress Party and the Christian Democratic Party, suffered moderate setbacks, but their results, 14,6 and 12,4 percent respectively, were still the second best in either parties' history (Aardahl 2003:7).

Tax questions played a dominant role in the debates preceding the elections, and the Conservative Party and the Progress Party fought over who would suggest the most radical tax cuts. Realizing that the public mood was swinging in favor of lower taxes,

the Social Democrats fought back, suggesting to reduce a number of excises and to raise the bracket of the surtax “so that nobody with a low or average income must pay this tax” (Stoltenberg 2001). More than one third of the voters regarded the tax issue as the most important issue of the campaign, which meant that it was the most important issue over all (Aardal 2003:16). The extent of the swing in the national mood is also evident from the fact that a staggering 73 percent of the respondents agreed fully or somewhat to the statement that “in the current economic situation there is room for substantial relieves in taxes and excises” (Aardal et al 2003:97). The clear winner of the tax debate was the Conservative Party, with 41 percent of the respondents claiming the party had the best tax policy (Aardal 2003:22).

Before the elections, the centrist parties had made it clear that they wished to form a new government together. As the Liberals fell under the 4 percent limit required to get the "additional seats" assigned to even out discrepancies between the number of votes and the number of seats in the Storting, and the Centre Party also performed worse than expected, it was however clear that this would not be possible. The Conservatives had all along wished to form a centre-right government with the Christian Democrats and the Liberals. The Christian Democrats had however been very critical of the Conservatives' focus on lowering the taxes. Their candidate for the position as prime minister, Kjell Magne Bondevik, had warned against the “materialistic attitude” evident in the election campaign (VG 2001a), and had given a flat no to most of the Conservatives proposed tax cuts (Ertzaas 2001). But in the end they agreed to enter into negotiations which led to an agreement on a governmental platform. After receiving answers to 54 questions (!) about the proposed new government's policies, the Progress Party decided to give the new government its support (VG 2001b). But Bondevik, who became prime minister of the new coalition, dismissed any possibility of a formal political agreement with the Progress Party, and the parliamentary basis for the government was therefore somewhat unclear.

4.2 The 2006 Tax Reform

4.2.1 The reform process

All of the three coalition partners' programs had references to the problem of the gap between the tax on capital and ordinary salaries and the failed split model. The Liberals still had the flat tax as their long term goal. Their program stated that "the difference between tax on capital income and labor income should be built down with the aim of eliminating it" and that "in this way the need for the split model will also disappear" (Venstre 2001). The Conservative Party did not go as far as to use the words "flat tax", but the result of their proposals seemed to be the same. The program said that the party's "aim to remove the surtax and to make the whole or parts of the social security contribution deposits in private pension accounts, will give approximately the same tax rate for different types of income" and that "consequently the split model can be removed" (Høyre 2001). Even the Christian Democrats, normally less eager to prioritize tax cuts, said in their program that the party wanted "to reduce the distance between tax on salaries and tax on capital" (Kristelig Folkeparti 2001). They had however an opening for a different way of achieving this, as the program stated that "increased capital tax can give room for cuts in other taxes" (Kristelig Folkeparti 2001). The Progress Party, the reluctant "parliamentary support" of the government, on the other hand, used a large section of their program to explain the disadvantages of progressive taxes. Though the party did not in fact use the words "flat tax", the program cannot be interpreted in any other way as the program said that the party "does not want to change the income distribution through progressive taxation" (Fremskrittspartiet 2001).

The government had by no means any landslide election victory behind it and the unclear relationship between the coalition and the Progress Party left it without clear support in parliament. Nor was there any sign of a crisis that could legitimate the need for radical reforms. On the contrary, the Norwegian economy was doing well. The "national mood" in favor of tax cuts in the election campaign and the disastrous

result for the Social Democrats could however be interpreted as giving quite a clear mandate for a tax reform. And from reading the programs of the new parliamentary majority, one could expect that everything would be set for a reform in the direction of a flat tax.

On the other hand, the two parties that were most clear in their wish for a flat tax were also the two in the weakest position to follow up their election promises. The Progress Party had since its foundation been a protest party, choosing “politically incorrect” views on a number of important issues, and it had thus acquired something of a pariah status. The Christian Democrats and the Liberals in particular were not comfortable with having too close relations with the party. The Liberal Party on the other hand had, as mentioned, failed to get more than four percent of the votes. This meant that the party only had two members of parliament. The only reason why they had been invited into government was because the Christian Democrats thought it would help them pull the Conservatives in a more centrist direction. In spite of the unique situation of having more ministers (three) than members of parliament, their chances of winning through with policies not favored by their coalition partners were limited.

“When you have a certain degree of stability in the economy and there are no outside factors that call for comprehensive reforms, it is an extremely complex task to change the system to the extent that a flat tax would imply.” (Olsen 2006 [interview])

In the negotiations on a governmental platform for the three parties the adviser to the Liberal Party leader, Geir Olsen (2006 [interview]), says that though they tried “as much as they could”, they realized “quite early” that it would be unrealistic to get the other parties with them on getting the flat tax into the platform. The party settled for trying to achieve “as many steps as possible towards a flatter system with less difference in the rates on labor and capital, and to remove as many deductions as possible” (ibid). The result of the negotiations did indeed go in this direction. The platform promised a reform of the income taxation where the basic deductions were to be increased and the surtax reduced, “to get a flatter and more just tax system with

less distance between the tax on labor income and tax on capital income”, and the goal was “changes that make it possible to remove the split model” (Politisk grunnlag for en Samarbeidsregjering 2001:14). To ensure this and a number of other reductions in taxes and excises, the agreement said that the government would give total tax cuts of about 25 billion NOK in the time period from 2001 to 2005.

The Stoltenberg government had not gotten the chance to present the planned white paper on tax reform before the elections in the fall of 2001. The new Bondevik 2 government immediately removed the tax on dividends, which the Stoltenberg government had proposed to leave in place despite the promise that it was to be preliminary, but it further delayed the tax reform. The coalition agreement said that the reform should be “*thoroughly researched*” and that “*all involved parties*” should be given the opportunity to contribute to the process (Politisk grunnlag for en Samarbeidsregjering 2001:14). In January 2002 the new minister of finance from the Conservatives, Per-Kristian Foss, appointed a new tax committee to prepare the reform.

In the mandate (Finansdepartementet 2006c) given to the committee headed by former minister of finance Arne Skaug it was quite clear what problem the reform was supposed to solve. It described how the tensions in the tax system created by the difference in top marginal tax rates on labor and capital income had increased, and how the changes to the split model had made it easier to have labor income taxed as capital income for self-employed and active owners. It went on to say that this may lead to an inefficient use of resources and a weakening of the distributional effects of the tax system. The Skaug Committee was then asked to “consider the scope for reductions in the difference between the top total marginal tax rate on labor income and capital income, and whether the present split model should be fully or partly abolished” (ibid). However, the committee was also told that “the tax system should contribute to a reduction of income differentials after tax” (ibid). The committee was furthermore asked to consider “how a net reduction of the tax level of about NOK 8-10 billion should be used and which tax reductions should be given the highest

priority”, and they were given the opportunity to propose changes in other parts of the tax system (ibid).

In the report that was presented in February 2003 (two months after the original deadline) the Skauge Committee did not use much space to discuss the possibilities of a flat tax. The report plainly stated that “in light of the great revenue and distribution effects” it is neither “realistic nor desirable” to reduce the marginal tax on labor income enough to make it possible to remove the split model (NOU 2003:9:185). Taking into consideration that other countries were reducing their business taxation, the committee also warned against increasing the tax on general income. After discussing several models that could replace the scolded split model, the committee concluded with proposing two main changes to the tax system: 1. A reduction in the top marginal tax rate on labor income by reducing the surtax and removing the supplementary employer’s social security contribution (SSC) on labor income for high wages, reaching a top marginal tax rate of 54.3 percent including employer’s SSC. 2. A “shareholder model” that implied that returns above an “imputed opportunity rate of return” on an investment are to be taxed as ordinary income, with marginal tax rates increasing from 28 percent to 48.16 percent ($0.28 + (1 - 0.28) * 0.28$). In addition, the committee proposed to gradually remove the net wealth tax replacing it with an increase in the taxation of real property and to increase the inheritance tax, arguing that this would bring Norway more in line with other OECD countries which in general have a higher tax on real property and inheritance, but no wealth tax. (Finansdepartementet 2006b)

The report was sent on a public hearing, in which 90 different organizations gave their comments to the committee’s suggestions (St.meld.nr.29 (2003-2004):22). The government finally presented its own recommendations in a white paper to the parliament 26 March 2004¹⁵. Of the 161 pages of the report, just a little more than

¹⁵ The late presentation of the White Paper led to protests from the Progress Party, the Centre Party and the Coast Party who claimed the 10 weeks the committee had left before the summer was too little for such an important reform (Innst. S. nr. 232 (2003-2004)).

one page was used to explain why the government would not consider the change to a flat tax. Instead the government basically followed up on the recommendations from the committee. It suggested maintaining a flat 28 percent tax rate on undistributed company income and “risk-free” capital income, and replacing the split model with a dividend taxation of personal shareholders, in which only dividends exceeding a computed risk-free return on the investment are subject to double taxation. The risk-free return was suggested set to the interest on 5-year governmental bonds (Innst. S. nr. 232 (2003-2004):37). For self-employed individuals the government suggested that the marginal taxes for personal income should apply for incomes exceeding this same risk free return. As the shareholder model would imply that the dividends would be taxed at 48,16 percent on the margin, the government suggested that the marginal tax rate on high personal income should be reduced “to about this level” (St.meld. nr. 29 (2003-2004):13). The government also suggested that the supplementary employer’s SSC on labor income for high salaries should be removed. Furthermore it proposed a reduction in the net wealth tax to the half of the present level within 2007, with the aim of completely removing it in the following years (Innst. S. nr. 232 (2003-2004):62). However, contrary to the suggestions of the tax committee, the government did not propose any increase in the taxation of real property. On the contrary and perhaps somewhat misplaced as a part of the reform proposal, it actually suggested abolishing taxation on “imputed rent from housing”, arguing that it was “an inappropriate tax base” (St.meld. nr. 29 (2003-2004):13).

The Progress Party was not pleased with the proposal for reform. In the party’s remarks to the White Paper (Innst.S.nr. 232 (2003-2004)) they complained that neither the Tax Committee nor the government had given enough consideration to other models. Arguing that all other tax systems than the flat tax would imply problems of demarcations and evasions, they found it “disturbing that the simplest tax system is not given more place and a more thorough consideration” (ibid p.13). Based on this, the party went to the unusual step of proposing that the White Paper should be “sent back to the government” (ibid). However, they did not make any clear public statements that the party actually wanted a flat tax.

But the reaction from the Progress Party did not come as a surprise to the government. According to finance minister Per-Kristian Foss (2006 [interview]), the government had all along been counting on the Social Democrats to secure the necessary support for the reform. Their support was in his opinion in any case necessary because the tax reform should be able to survive a change in government.

“A government must always count in the possibility that one might get the majority against oneself in the next elections. A new government would have to include the Social Democrats, and it was therefore important that they were in on it.” (Foss 2006 [interview])

The Social Democrats, along with the Centre Party, did support the most important of the proposed changes, the introduction of the “shareholder model”. Both parties agreed that the model would lead to a “more just taxation because labor income and capital income will be taxed more similarly” (Innst. S. nr. 232 (2003-2004):37). However, the same parties did not agree that it was necessary to reduce the highest marginal taxes on labor income in order to remove the split model. On the contrary, they claimed that the problem of labor income being taken out as dividends would be “manageable” also with the current highest marginal tax of 55,3 percent (ibid p.25)

The reform was suggested phased in over a period of three years, and the new shareholder model included so many complex challenges that its implementation was postponed until 2006. In the budget for 2005 the government thus proposed that as a first step the surtaxes should be reduced with 2,5 percentage points in level 1 and 4 percentage points in level 2, reducing the maximum marginal rate to 51,3 percent (61,5 percent including employer’s SSC). The budget proposal said that “the reform should have a balanced distributional profile, and that wage earners on different income levels should take part in the tax cuts” (B.innst.S.nr.1 (2004-2005)). The proposal thus also included an increase in the basic allowance. However, the proposal was not “balanced” enough for the government’s budget partner the Progress Party, who claimed the budget had an “unsocial profile” (Ellingsen 2004). One of the main changes of the resulting budget agreement between the government and the Progress

Party was thus that the lower surtax rate was only cut with 1,5 percentage points, while the basic allowance was further increased (B.innst.S.nr.I (2004-2005)).

"If we give tax cuts, we need to give it to everybody. We gave more tax cuts than the government, but it was more evenly distributed. It is hard to defend that we should give great tax cuts to those who earn more than half a million, while those who earn 150 000 get tax increases or at least do not get tax cuts. So that's why we just took some of the tax cuts from the top and moved it to the bottom. That was our social profile." (Hagesæter 2006 [interview])

The parties of the Bondevik 2 government suffered a crushing defeat in the 2005 parliamentary elections. However, before leaving office the government delivered its final budget proposition. Since in 2006 the split model was to be replaced with the shareholder model, the government again proposed a reduction in the surtax, reducing the rate in bracket 1 from 12 percent to 7 percent and in bracket 2 from 15.5 percent to 12 percent. As called for in the White Paper, the proposal also suggested abolishing the supplementary employer's social security contribution on high wage income.

The parties of the new government (Stoltenberg 2), the Social Democrats, the Socialist Left Party and the Centre Party, had used the "unsocial" tax cuts of the Bondevik 2 government as their main campaign topic, claiming it had prioritized "tax cuts to the rich" at the expense of public welfare (Aardal 2006:21). This and the earlier mentioned comments the same parties had given to the reform proposal meant that it came as quite a surprise when the new government did not in fact roll back the tax cuts in the budget proposal of the out-going government. On the contrary, the cut in bracket 2 of the surtax was left unchanged, while the cut in the rate in bracket 1 was reduced only to 3 percentage points (St.prp. nr. 1 Tillegg nr. 1(2005-2006):54). The new government thus taxed the people they had called "rich" in the election campaign with exactly the same rate as the Bondevik 2 government had wanted, but made the middle class pay more. The Stoltenberg 2 government also maintained the proposal of abolishing the supplementary employer's social security contribution on

wage income, and the maximum marginal tax rate (including employer's social security contribution) was reduced from 61.5 per cent to 54.3 per cent, just like the previous government had proposed (ibid p.47).

4.2.2 The arguments

Value acceptability

Whether or not a proposed reform would be “fair” seems to be of prime importance in Norwegian tax politics, and as anticipated in the theory chapter there are clear proofs that the fairness of a tax proposal is judged primarily by the distribution of the changes it would imply. The parties of the Bondevik 2 government were painfully aware of the fact that the results of their tax reform would be explained by the media and the opposition parties with tables showing how much the taxes would change for different income groups. The government did their best to make their proposed reform “balanced”, but faced the difficult fact that every percentage point cut in the top marginal taxes gives tax cuts to the highest earners that are extremely expensive to match with increases in the personal allowance.

“We looked at the distributional tables. How would it affect a family with this and this many children, and someone who earned this and this much. (...) We were concerned about the profile, and we preferred to take more in surtaxes and rather increase the personal allowance. But it was difficult, because everyone benefits when you increase the allowance, but there are few who pay the highest surtaxes.”
(Steensnæs 2006 [interview])

The way fairness is judged in terms of change is perhaps most clearly illustrated by the fact that, as mentioned in chapter 4.1.3, the Christian Democrats did not want to introduce the new top bracket in the surtax in 2000. However, once the new bracket was in place, they were only very reluctantly willing to make reductions in it, and argued that any cuts had to be matched with increases in the personal allowance. Even quite modest changes to make the tax system flatter by reducing the top

marginal rate thus faced serious opposition not only from the leftist parties, but also from within the government and, as we have seen, even from the Progress Party. The flat tax proposal would mean much more drastic cuts in the marginal tax, and opposition against it was even stronger.

“It’s not acceptable in my view that one group has to pay so that those earning more can come in a more favorable position.” (Steensnæs 2006 [interview])

Per-Kristian Foss says he thinks the reason why the Progress Party did not chose to advocate the flat tax more publicly, was that they faced the dilemma of the calculations on changes:

“I don’t think they would like the calculations that said that with this system Carl I. Hagen [then chairman of the Progress Party] would get 150 000 in tax cuts, but someone who works in the supermarket would get a tax increase of 75 000. This kind of examples and the tables showing the changes are politically lethal.” (Foss 2006 [interview])

Hagesæter from the Progress Party (2006 [interview]) admits that they were indeed “concerned with how things are perceived”, because they “know how the tabloids present it”. He says that though there are few people in Norway with more than a million in salary, they knew that if they publicly went for a flat tax, “the focus would be that a person with 150 000 in salary would get small tax cuts, while one with 2,5 million would get big tax cuts” (ibid). Hagesæter goes as far as saying that because of this fact, it is in his opinion necessary to introduce the flat tax in a way that ensures that “more or less everybody gets a tax cut” (ibid).

“We simply can’t make it so that some get tax cuts that are to be financed with increased taxes for somebody else. It would be impossible to get support for it. It would be simpler to sell the idea that some get less tax cuts than others, than a reform where some get increases in tax and others tax cuts.” (Hagesæter 2006 [interview])

According to Geir Olsen (2006 [interview]), the advisor to the leader of the Liberal Party, this fear of the flat tax resulting in someone having to pay more, was not a major concern for them. He says the models that they had been looking at implied setting the flat rate at 32 percent, something which indeed would imply a higher tax rate for some groups. In their opinion it was enough to argue that the proposal would mean a fair system. Olsen (ibid) says “it is still not very well explained why people should pay a greater share of the highest incomes”.

“We think it would have a strong legitimacy in the population, that it is fair that everyone pays the same rate” (Olsen 2006 [interview])

The Liberal Party’s program said that the “surtax is a bad solution for social redistribution” (Venstre 2001). According to Olsen (2006 [interview]) the Liberals believed that redistribution should be done on the expense side of the budget, and that “it is unfortunate to do it on the income side”. The Progress Party went much further however, questioning the necessity of redistribution altogether. Their program argued against the principle of the progressive system, stating that “the distribution of income in society first and foremost should be a result of the individuals free choice to value labor, income and leisure” (Fremskrittspartiet 2001). However, the party believed that progressive rates in taxation of wages have aggravated the differences in income before tax. In their opinion, if it had not been for the extra taxation on high incomes, employers would not have offered as high salaries for these income groups. With a sudden change to a flat tax system, this group would thus get a lot more than they would have had if there had never been a progressive taxation. To limit this “unfair” difference in income, Hagesæter (2006 [interview]) says they have been considering whether it would be possible to reach an understanding with the employers and the labor unions that the highest income groups would accept a smaller yearly increase in their wages in exchange for a gradual reduction of the surtaxes towards a flat tax.

On the other hand, the Christian Democrats clearly believed that the tax system could and should be used for social redistribution. The party leader Dagfinn Høybråten

(2004) stated that a “central issue for the Christian Democrats in the work on the tax reform is that the tax system contributes to a fair distribution, and secures redistribution from those that have high incomes to those that have low incomes”. It was therefore “important for the Christian Democrats to maintain a progressive tax system and *not to introduce a flat tax*” (ibid, emphasis added). Steensnæs (2006 [interview]) says that he just doesn’t see that the flat tax could work fairly, because it would not give a fair distribution between those who earn the most and those who earn the least. In his view the flat tax would mean that the rich would be let off more easily and he claims that “it is not possible to set the personal allowance high enough to give a fair taxation” (Steensnæs 2006 [interview]). But also for Foss (2006 [interview]) from the Conservative Party, the distributional aspect of the tax system was one of the major arguments against the flat tax, because “those who would profit from the flat tax are those with middle and high income”. The government’s White Paper thus stated that the “goal of redistribution makes it difficult to change to a flat tax” (St.mld. nr. 29 (2003-2004):119). The remarks of the finance fractions of the coalition government followed in the same vein, saying that “a model with a pure flat tax is simple, but that it also therefore may have unfortunate redistribution effects” (Innst. S. nr. 232 (2003-2004):58).

“The most important [argument] is really that a flat tax does not give a fair distribution of the tax burden between those who earn the most and those who earn the least.” (Steensnæs 2006 [interview])

A natural question is therefore whether today’s system really works to redistribute between the “rich” and the “poor”, in the sense that high earners really pay a larger share than the low earners. Statistics of how much different income groups actually pay in taxes show that there is indeed a real progression in the share of the income that is paid. That is, as long as you study income groups divided into quartiles or deciles. When the groups are divided into smaller units, however, a different image appears. As showed in table 4.1, in 2003 the 1 percent of the Norwegian population with the highest income paid about 20 percent of their income in taxes. In other

words, this group paid a clearly smaller share of their income than the population average, which was more than 24 percent. If the scope is narrowed down even further to the 0,1 percent of the population with the highest income, the impression of a progressive system that taxes “the rich” disappears altogether. This group paid on average only 10,6 percent of their income in taxes in 2003. This is a share only one percentage point higher than the 25 percent of the population with the lowest income, and only about a third of the share that the top 25 percent pay. The tax system thus seems to be a clear example of the way the “Scandinavian model” implies an “exploitation” of the middle class (Barth et al 2003:54).

Table 4.1 Average paid taxes in percentage of gross income for different income groups in 2003 (residents above 17 years old).

All	1.quartile	2. quartile	3. quartile	4. quartile	Top 5%	Top 1%	Top 0,1%
24,	9,6	18,4	23,8	28	27,5	20,6	10,6

Source: Statistisk Sentralbyrå (2005)

The reason for this unequal sharing of the tax burden is of course the fact that for the highest earners the income consists mainly of capital income, which has been taxed only at a 28 percent rate. This group also has the knowledge and resources necessary to efficiently use the different exemptions in order to reduce their taxes to a minimum. Acknowledging this fact, the Skauge Committee concluded that it is “doubtful whether a strongly progressive taxation of labor income in combination with a low and flat tax of capital income has the intended distributional consequences”, but that high taxes on wages in practice easily become “symbolic policies without any particular importance” (NOU 2003:9:120).

In explaining why the flat tax is unlikely to be introduced in Norway, Foss (2006 [interview]) says that he does not think “it is politically acceptable that the millionaires wouldn’t have to pay more than 30 percent at the marginal rate”. When confronted with the fact that it seems to have been perfectly politically acceptable that the richest individuals only pay ten percent of their income, the former finance minister says that this is when “you put together capital income, income from business and labor wages. But if you look only at labor wages, for example the CEO

of Hydro who earns 8 millions, then it is not acceptable that this kind of people, who now pay 50 percent in taxes, should only pay 30 percent” (Foss 2006 [interview]). The reality is of course that it is indeed politically acceptable that the richest pay a smaller share in taxes. The reason is the mobility of capital. As Steensnæs (2006 [interview]) puts it when faced with the same question of whether today’s distribution is fair, “one has to remember that tax policies cannot be looked at only from a national perspective, global mobility means that businesses will move if one exceeds certain limits.” Because it is not considered possible to tax capital income any higher, policy makers have simply resigned to create a tax system that redistributes between wage earners.

“It is sensible to have a division between capital and wages because the global economy sets limits for how hard you can tax capital.” (Foss 2006 [interview])

In the report from the Stølen Committee two of the members of the committee, Ole Gjem-Onstad and Hilde Mathisen Sletteberg, argued in a minority comment that “distributional concerns do not represent an obstacle for a major change to a flatter tax” (NOU 1999:7:22). Gjems-Onstad (2006 [interview]), professor in tax law, says that it is clear that today’s system redistributes income between wage earners, and that a flat tax would weaken this. However, he poses the question whether this redistribution really matters all that much, or if “maybe it is rather so that the differences in wages between workers are the differences that are most fair, while the unfair difference is between those who earn 100 million in capital income and those who earn 300 000 in wages” (ibid). Taking into consideration that in today’s system, there are bigger differences between the really rich and everybody else *after* tax than *before* tax, Gjems-Onstad (2006 [interview]) claims that introducing a flat tax poses no redistribution problem. But again, he says he is fully aware that it is the big difference between the wage earners that the media will be interested in:

“The tax debate in Norway is revolving around groups of wage earners, and those that earn 2 million we call “the rich”. But the actually rich earn 100 million in capital income.” (Gjems-Onstad 2006 [interview])

The fact that increasing the taxation on the rich does not yield much revenue is another reason why policy makers have accepted leaving them alone. Gjems-Onstad (ibid) explains that he learned something about how deep this way of thinking goes among the bureaucrats in the Ministry of Finance, during the work with the report on flat tax. According to him, some of the representatives from the ministry said that “they refused to be very concerned about the rich, because they are less than 1 percent of the population” (ibid). As part of the work with the report, Gjems-Onstad (1999) had made a closer investigation on the 10 000 individuals with the highest income in Norway. But the other committee members merely asked him “what is 10 000 out of the more than 3 million tax payers in Norway? So what if the system doesn’t work for them?” (Gjems-Onstad 2006 [interview])

“They said we have a system that redistributes between big groups of people, and we are satisfied with that. So then you can sit there and scream, and say that it is a strange use of the language when you call somebody that earns half a million or a million “rich”” (Gjems-Onstad 2006 [interview])

In the above mentioned conversation with Foss, the former minister of finance was of course quick to add that what the new reform did was exactly to change the system in which people with a high capital income paid much less in taxes than everybody else. Also Høybråten (2004) argued that a main reason for the tax reform was to remove this unfairness. And the new system did indeed imply a stricter taxation of capital. However, it is not clear if the changes really make much difference for the taxation of the really rich. An incident that happened to Gjems-Onstad is revealing in this regard:

“I had a lecture about the new tax system for a legal firm, and I told them that if you have 10 million and put them into a limited company, then with the computed risk-free return [at the time at 2 percent] you can take out 200 000 tax free every year. Then one man raised his hand and asked “but, why 10 million, why not 100, then I can take out 2 million each year?” (Gjems-Onstad 2006 [interview])

The problem that the tax system does not really affect the wealthiest part of the population has still not been solved. The new tax is not progressive; on the contrary it merely taxes according to the size of the capital that has been invested. As the really rich generally do not need to take out more dividends than the amount of risk-free return, they can continue to avoid paying more taxes. Young entrepreneurs who are starting a new company, on the other hand, normally don't have anything else to live off, and they are forced to pay the 48 percent tax rate, even if their income is fairly low. Rather than taxing the really rich harder, Norway has according to Gjems-Onstad (ibid), changed to a system that has made it significantly more difficult to start new companies.

“I’m not really a big supporter of taxing the rich harder, but I think it would be nice if an educated society could have a tax debate that deals with realities” (Gjems-Onstad 2006 [interview])

Technical and Political feasibility

Also in Norway, the technical simplicity of the flat tax was seen as strengthening the case for the proposal. Hagesæter (2006 [interview]) says that the simplification for him personally was the most important argument. The flat tax would in his opinion be “simple to control and simple to understand”, both for the tax payers, the businesses and for the tax authorities. In their comments to the government’s reform proposal, the Progress Party argued that the proposed system was too complicated. They claimed that all other systems than the flat tax “have in common the fact that they involve demarcation, documentation and evasion problems” giving “unnecessary work places both in the public and in the private sector” (Innst. S. nr. 232 (2003-2004):14). Furthermore, as in the Progress Party’s view “tax rules concern all citizens”, they believed they should be adapted to people’s need to understand them (ibid). The Liberal Party also saw the simplicity of the flat tax as a crucial argument. According to Olsen (2006 [interview]) all other models that attempt to make taxation more “fair” would mean more complicated systems. In Olsen’s view, the most fair tax system is a tax system that can be understood by ordinary people, and everyone

paying one rate above a certain level is a principle that it is easy to relate to. The Liberals also believed that a flat tax system would remove the incentives for illegal tax avoidance and “raise the Norwegian moral” (Sponheim 2002).

The White Paper on the tax reform admitted that “a flat tax with a relatively big personal allowance for personal tax payers has its strength in its simplicity” (St.meld. nr. 29 (2003-2004):119). However, Foss (2006 [interview]) claims that the main reason why the tax system is complex and hard to understand is not the taxation of personal income but the laws regulating corporate income taxes, and this would not change with a flat tax. What complicates the corporate taxation is, according to Foss, the fact that globalization makes control difficult because incomes and expenses can easily be moved (ibid). Foss (2005b) claims that an equal tax rate would not make the taxation much easier on personal income either, unless you remove the earlier mentioned exemptions. Furthermore, he does not believe that a flat tax would do much to reduce the motivation to illegally avoid taxes, at least not if the rate would be set higher than today’s 28 percent on general income (ibid).

However, it seems clear that the tax reform at least did not make the tax system much simpler. Indeed, in the hearing after the Skauge Committee presented their report, even the Norwegian Tax Administration itself strongly advised the government against the shareholder model, arguing that it would be “difficult to understand and challenging to relate to for the tax payers” and that it “would make the tax payers’ possibilities for controlling the tax base almost illusory” (St.mld. nr 29 (2003-2004):83). Hagesæter (2006 [interview]) claims that the Norwegian tax system is now so incredibly complex that even the politicians themselves have problems understanding it:

“To tell it straight: There are incredibly few here in this house [the parliament] who really understand the tax system. As the party’s spokesperson on tax issues I spent quite a lot of time on the tax reform, and my impression was that even in the Finance Committee there were many who did not understand everything about the reform” (Hagesæter 2006 [interview])

As expected in the theory chapter, the flat tax faced serious problems when it came to its “political feasibility” in Norway, and it seems that the difficulty of removing the exemptions in the current tax system was truly a formidable barrier to the adoption of the proposal. As Geir Olsen (2006 [interview]) puts it, “we have a complex system where there are many special interests behind every deduction and every post.” In particular, there seem to be a general agreement among my respondents that the deduction on interest payments is almost impossible to remove. To Foss (2006 [interview]), this is the main problem with the idea of a flat tax. He says that removing or setting a ceiling on the deduction on interest payments would imply a “dramatic” generational redistribution from the parent generation to the newly established. The parent generation has paid down their loans on the house with the deductions, some of it even under the pre-1992 tax regime where deductions were made based on the tax payer’s marginal tax rate. To give these people, that may now pay the top surtaxes, the tax cuts that the change to a flat tax would imply, at the same time as the younger generation would lose completely the possibility to deduct interest payments on their house loans and student loans, would in Foss’ opinion mean a “considerable injustice” (ibid). Steensnæs (2006 [interview]) follows the same line of argument, saying that it would have “very negative consequences for young families that are depending on help through this system to finance their new homes.” Ideally, Steensnæs says, he would have wanted to limit the deductions to loans for the most fundamental needs, but that the possibilities for evasions under such a scheme would in his opinion be too great. Even the Progress Party argues along similar lines, and they admit that they have concluded that even with the introduction of a flat tax, they would not touch the deduction on interest payments (Hagesæter 2006 [interview]). According to Hagesæter, it would entail too much of a strain on the younger generation that are about to enter the housing market:

“It’s the generational distribution that is important to us. Without a deduction on the interest rates, young people who have just finished their studies would have great problems buying a house” (Hagesæter 2006 [interview])

But the respondents also argue that a main problem is that it would be politically unacceptable to remove the exemptions that most people have been counting on when they raised their loans. Olsen (2006 [interview]) says that the Liberal Party “in principle” would want to have only one personal allowance, and no other deductions, but that it would be unfair to just suddenly remove the deduction on interest payment. The model that they had been looking at therefore implied to “phase out the deduction on interest payments over several years, for example ten, so that people would have time to adjust” (ibid). Foss (2006 [interview]) brings up the same idea and says that it would indeed be possible to remove the deduction on interest payments if it were done gradually, saying that in ten years it would be gone. However, Foss says that such long-term planning is extremely difficult in real life politics. A tax reform made over a period of ten years means dealing with three differently composed parliaments. All the parties would have to stick with the deal through even more different party congresses. In Foss’ opinion such a deal is “utopian” (ibid).

Steensnæs (2006 [interview]) says they were aware that the deduction on interest payments has been under “constant criticism” from many tax experts. The complaint has mainly been that it contributes to a system that gives disproportionate incentives to invest in housing compared to other investment possibilities. However, most experts have argued that the problem should be solved through increasing the taxation of real estate. The rationale for the exemption on interest payments has been that it is the net return on capital that should be taxed. Interest payments on loans should therefore have their counterpart in yields from the investment that the loans were used for (NOU 1999:7:130). Based on this thinking, house owners were taxed on “imputed rent from housing”. However, over the years the value of this “rent” gradually diminished and the tax became negligible for most tax payers. The Stølen Committee was thus of the opinion that “distortions in the tax system should be corrected where the distortion is” and that the deduction of interest rates should be kept, but that taxation on housing should be increased (ibid p.142). The Skauge Committee followed the same line of thinking and also recommended a radical

increase in the taxation of real estate. The committee pointed to the fact that most OECD countries that do not tax housing have also abolished or severely limited the deduction on interest rates (NOU 2003:9:268). Knowing the political agenda of the government, it therefore argued that if the tax on housing were to be removed, the “technical and juridical basis for deductions of private interests on loans would be considerably weakened” (ibid).

As mentioned in chapter 4.2.1, the Bondevik 2 government did abolish the tax on imputed rent from housing, as part of the tax reform. Foss (2006 [interview]) admits that “from economical logic” it would have been natural to see this in connection with the deductions on interest payments, but that the removal of the taxation on housing was “for political reasons”. Foss says that investment in one’s own home is “the one area where the tax in Norway is low, and also the area where we are most untypical in relation to the rest of Europe” (ibid). Olsen (2006 [interview]) agrees that it was “out of the question to link the removal of the taxation on imputed rent from housing to reductions in the deduction on interest payments”. According to Foss (2006 [interview]), if the deduction on interest payments were to be removed as a part of a flat tax reform and people would be told that they would be compensated with tax cuts, most people would answer that “we have heard *that* before”. In Foss’ opinion, the experiences of broken promises in the past mean that confidence in the politicians in this area is very limited (ibid).

“I agree that it would be economically logical that one should remove both [the interest deduction and the taxation on housing] at the same time, but it would be politically impossible” (Foss 2006 [interview])

If the understanding of fairness we have seen in the previous subchapter is brought into the discussion, it would however be obvious that to abolish the deduction on interest payments would clearly target the rich. The size of the loans the banks are willing to give depends on the income of the applicants. As a natural consequence it is thus the part of the population with the highest income that has the highest loans, as we can see in table 4.2. My respondents are of course aware of this. Hagesæter (2006

[interview]) admits that it is indeed the “rich” that gain the most from the deduction of interest payments, and that “those in the worst financial conditions can’t even afford to buy a house”. Foss (2006 [interview]) says that precisely because of the uneven distribution of the benefit of the deduction on interest payments, a flat tax system would *have to* limit it, because otherwise the reform would be too unfair.

Table 4.2 Household income and yearly interest expenses according to deciles.

Decil	Income	Interest
All	298000	23310
1	71000	6720
2	124000	4510
3	159000	9920
4	193000	13940
5	231000	16770
6	278000	24140
7	332000	32630
8	389000	38140
9	462000	40010
10	738000	46270

Source: Fjærli (2002)

“A real flat tax system must have a ceiling on deductions on interest payments. Without it, the proposal is just a big present to the ones with the highest incomes” (Foss 2006 [interview])

It seems however that it is difficult enough to cut down on the multitude of tax allowances that are much smaller both in size and in political importance. The Skauge Committee had suggested to remove a number of the deductions: the allowance for labor union fees, the allowance for gifts to voluntary organizations, the allowance for work related travel expenses, the fishermen's and seamen's allowance, the tax credit for home savings scheme for youths, the old age and disability allowance, the allowance for high expenses related to sickness and the parent allowance for documented expenditure on childcare. It also suggested abolishing the division into two income tax classes. In the hearing a number of organizations protested against these proposals: the labor unions protested against removing the exemption on the

labor union fee, the Norwegian Shipowners' Association and the fishermen unions protested against removing the fishermen's and seamen's allowance, the Norwegian Savings Banks Association objected to removing the home savings scheme, the NGOs wanted to keep the deduction on gifts to charitable organizations, and the pensioners organizations wanted the old age and disability allowance to remain unchanged. (St.mld.nr.29 (2003-2004):61-65)

The White Paper on the tax reform said that "the number and extent of special income deductions should be limited" (ibid p.65). The coalition agreement had however mentioned the increase in several deductions, among them the allowance applicable to gifts to charitable organizations which the government had introduced only a little more than a month before the Skauge Committee presented its report. The White Paper thus added that there "should still be room for specially prioritized deductions" (ibid). Though the government estimated an increase in tax revenue of 5,3-6,3 billion NOK from the elimination of deductions, the proposal said nothing about which deductions in particular the government wanted to reduce (ibid p.150). The Progress Party warned in their comments that "such a cut would be unwise", and argued that at least six different deductions had to be kept in place (Innst.S. nr.232 (2003-2004):22). When asked how this fits with the party's program that called for a tax system with "few deduction possibilities" (Fremskrittspartiet 2001), Hagesæter (2006 [interview]) claims that this was "in relation to the proposed reform" and that with the introduction of a flat tax system they would be willing to cut more of the deductions. The Liberal Party, more in line with their program, had on the other hand wished to go further, wanting to leave only the personal allowance and the deduction on interest payments. But according to Olsen (2006 [interview]) they faced strong opposition, mainly from the Christian Democrats who opposed both their wish to remove the division into different income classes and several of the proposed cuts in deductions. In the budget for 2005 the government suggested to reduce the daily commuting allowance, to abolish the per diem allowance and the tax exemption for per diem compensation for commuters, and to abolish the dependency allowance and the tax exemption for free diet for employees on the continental shelf and for

seamen's wage supplements. The Progress Party opposed all of these cuts in their alternative budget, but supported them as a part of the budget agreement. On the other hand, the government had no problem getting the approval to double the allowance applicable to gifts to charitable organizations and to increase the parent allowance. (Bud.Innst.S.nr.1 (2004-2005))

"We got the approval for the principle, but not for which [deductions] that actually were going to be cut. We removed some of them in the budget, but even that caused a lot of noise." (Olsen 2006 [interview])

Budgetary implications

The cuts in revenue that a flat tax would imply and the uncertainty of the size of these cuts were, as expected in the theory part, also important arguments against the flat tax in Norway. The program of the Liberal Party said that the flat tax reform should be introduced "without reducing the public tax revenue" (Venstre 2001). The report of the Stølen Committee had however showed that it would be difficult to introduce any kind of flat tax model without either cutting the revenue or increase other taxes. Both the Liberals and the Christian Democrats had the change to a more "green" taxation in their programs, and wanted a change "from tax on labor to taxes on environmental destruction and consumption of resources" (Kristelig Folkeparti 2001). Any change in the direction of a "green tax reform" was however made unlikely by the fact that the Conservative Party had promised to remove or reduce several of the green taxes already in place. The governmental platform even stated that the government wanted to cut two of these "green" taxes, namely the taxes on electricity and air travel (Politisk grunnlag for en Samarbeidsregjering 2001:14). It thus seemed like any tax cuts involved in the change to a flat tax would have to mean cuts in overall revenue.

"The Liberal Party had in their program a flat tax without tax reductions. I said I could gladly introduce a flat tax if I was allowed to use 50 billion in tax cuts, but there was no interest in that, so the question died quickly." (Foss 2006 [interview])

The most important reasons why the flat tax seemed to necessitate an unacceptable cut in revenue seem to be the necessity of making the reform “balanced” and the difficulties involved in removing the exemptions, as described in the preceding subchapters. Steensnæs (2006 [interview]) says that to make the flat tax fair, the personal allowance would have to be set at such a high level that it would mean a radical loss of revenue. The Progress Party, which unlike the Christian Democrats had greater overall tax cuts as a clear political goal, had calculated that if the exemption on interest payments was to be left in place, it would be necessary to cut the tax revenue with a “minimum of 10-20 billion” (Hagesæter 2006 [interview]). However, if the personal allowance was to be set to fulfill the wish that “everybody” would get a tax cut, they would need to cut somewhere between 30 to 40 billion NOK (Hagesæter 2006 [interview]). Foss (2006 [interview]) claims it would be even more expensive, estimating that with a tax rate of 30 and a substantial personal allowance, it would mean a cut in revenue of 50 to 60 billion.

“A lot of the flat tax debate in Norway is characterized by the fact that people have not made calculations on what it would cost. (...) I simply do not believe that Norwegian politicians would prioritize tens of billions [NOK] to introduce a flat tax” (Gjems-Onstad 2006 [interview])

According to Foss (2005b) the “Achilles’ heel” of the flat tax proposal is the rate at which it has to be set to in order to maintain the same revenue as the present system. While the Liberal Party had proposed setting the flat tax at 32 percent, Foss (2006 [interview]) feared that even a 30 percent rate would be likely to “scare businesses out of the country”. The White Paper argued that increasing the tax on capital “would have a negative effect on the Norwegian economy” (St.mld. nr.29 (2003-2004):119). In explaining why they would not support a flat tax, the finance fractions of the government parties also argued in their comments to the White Paper that “internationally the development is in direction of lower taxes on business profits” and that Norway therefore “should keep a competitive taxation of businesses exposed to competition” (Innst. S. nr. 232 (2003-2004):57). Because “Norway already has the

highest possible tax rate on almost all other areas”, Foss (2006 [interview]) further claims it would be difficult to cover the revenue loss with an increase in other taxes. Consequently, the White Paper on tax reform stated that, in addition to the question of redistribution, “the need for tax income” was the primary reason why a change to a flat tax was not possible (St.mld. nr.29 (2003-2004):119).

“A country with a welfare state like the Norwegian cannot live with a tax income decided by the global economy. Our dilemma is that our welfare state is too expensive to be financed with 28 percent tax on everything. (...) The public sector in Scandinavia can’t be financed with as low taxes as they have in Estonia today. And my assertion is that in ten years, neither will the Estonian state.” (Foss 2006 [interview])

In Foss’ opinion, the main difference between Norway and Estonia is the difference in the taxes as a fraction of gross domestic product (ibid). He says that as long as the country has a small public sector, it is possible to survive with low taxes, but that the Norwegian welfare state has a greater need for revenue. In 2004 the total accrued taxes as a percentage of GDP in Norway was at 44,9 percent, or 42 percent if one adjusts for the petroleum activity (Finansdepartementet 2006b). That is indeed somewhat higher than the corresponding number in Estonia, which in 1994, the year of the introduction of their tax reform, was 36,4 percent (Ministry of Finance of the Republic of Estonia 2005). However, a more relevant comparison would perhaps be the extent to which labor income is taxed in the two countries. In Estonia the rate of the social tax paid by the employers is, as we have seen, 33 percent. The corresponding figure in Norway is 14,1 percent, 18,9 percentage points lower. As mentioned in chapter 4.1.2, the Stølen Committee had calculated that, without removing any exemptions, a flat tax would have to be set to 38,5 percent. One percentage point in the employer’s social security contribution generates approximately the same as one percentage point in tax on general income (Gjems-Onstad 2006 [e-mail to the author]). Thus in order to set a flat tax in Norway to 26 percent as the flat tax originally was in Estonia in 1994, the government could

actually have followed the flat tax model of the Stølen report while simultaneously raising the employer's SSC with 12,5 percentage points, and still have a lower overall taxation of labor than Estonia. Such a drastic change in the employer's SSC would of course not be possible to do from one year to the next, most importantly because it would force the employers to make an unacceptable cut in the salaries paid to their employees. However, this theoretical solution suggests that the overall tax burden is perhaps not the main reason why a flat tax has not been seen as a possible option in Norway. Per-Kristian Foss (2006 [interview]) strengthens this suspicion when he admits that even if he had the possibility to use another 50 billion in tax cuts, he would still not prioritize a change to a flat tax:

"If I had 50 billion to use on tax cuts in addition to the 23,5 billion that our government gave, I would use them in other ways. I would reduce some excises that have become way too high or that have become totally meaningless, for example on sugar and chocolate. Then I would reduce the excises on cars. Then I would maybe do something about the marginal taxes." (Foss 2006 [interview])

The great question in judging the revenue effect of a flat tax is however to what extent the simplicity and the lower marginal rates of such a change would create dynamic effects that would increase the revenue. The Stølen Committee did a thorough review of the research on these effects. Their conclusion was that "economical theoretical analyses do not give any clear conclusions on the consequences of flat tax on economic efficiency", but that empirical research seems to indicate a positive effect in the form of increased labor supply (NOU 1999:7:120). The committee's conclusion was however, as mentioned in chapter 4.1.2, that the effects were so uncertain that they chose to disregard them in their evaluation of different models. The Liberal Party on the other hand was according to Olsen (2006 [interview]) confident that a change to a flat tax would give efficiency gains. He says that both the tax cuts involved and the change to a flat rate in itself would have "dynamic effects". As evidence Olsen points to the fact that following the tax cuts the last years, the revenue has increased more than what has been estimated. Foss (2006

[interview]), however, doubts that the change to a flat tax would give any such effects. He says that the labor productivity in Norway is already very high, and argues that it is not among the highest earners that the country would earn much on a further increase in the labor supply. In his opinion, the potential for an increase in the labor supply in Norway today lies in making people approaching retirement age work a little longer, and in helping people with disabilities or health problems enter the labor market, “and this you don’t solve by making the taxation flat” (ibid).

”Whether or not lower taxes will lead to greater efficiency is a discussion with so many disagreements and so much uncertainty, that you won’t convince anyone to make changes on that scale based on it. What you look at is the loss of revenue the first year. That’s what needs to be covered.” (Gjems-Onstad 2006 [interview])

The Progress Party also believed that a flat tax would lead to efficiency gains that would mean an increase in revenue. Hagesæter (2006 [interview]) claims that the flat tax would lead to a “better development in the economic growth, more businesses, and increased employment”. According to Hagesæter they realize that these effects would not become visible the first year, but the immediate loss in revenue does not concern him all that much because of the income Norway has from the petroleum industry (ibid). He claims that the oil money gives Norway a unique possibility to be the first of the Western European countries to introduce a flat tax, as even a cut in revenue of 40 billion NOK would not create a deficit in the country’s budget. The country could thus afford to “invest” in a more efficient tax system, and harvest the benefits of such a system after a few years (ibid). Such an assessment is however made easier by the fact that the Progress Party, unlike the rest of the Norwegian parties and almost all economic experts, believes that the state could use considerably more of the oil revenues than it does today, without damaging the economy.

“30-40 billion in tax cuts does not exactly constitute a crisis when we have [in 2006 an estimated] surplus of 350 billion” (Hagesæter 2006 [interview])

4.2.3 The policy entrepreneurs

As mentioned in chapter 4.1.2, Carl I. Hagen, the chairman of the Progress Party, functioned as the “policy entrepreneur” who first attempted to couple the flat tax proposal to a relevant problem, in the spring of 1997. The same basic problem, the split model’s failure to provide a workable and fair bridging of the gap between the taxation of capital and wages, remained on the agenda from then on and until the shareholder model was introduced in 2006. However, when a policy window for tax reform opened after the 2001 elections, Carl I. Hagen was not able to enter into the new government and come into a position where he could more efficiently influence the direction of the reform in question. On the other hand, as mentioned earlier, Hagen and the Progress Party chose to abstain from actively promoting the proposal publicly, both before the election and during the time of the reform. Hagesæter admits that they were concerned with how the media would present it, in other words that the proposal would be unpopular. Hagen was indeed known for his great ability to read the public opinion. It may seem like he in the fall of 2004 had a feeling that the “national mood” had changed and that the public support for further cuts in the top tax rates was dwindling. In any case, Hagen’s adherence to the flat tax proposal was not strong enough to stop him and his party from opposing the government’s attempt to make the taxation more flat, even if the party claims that it was because they prioritized tax cuts to the lowest earners.

The Liberal Party leader Lars Sponheim on the other hand, had not made any secret about his party’s wish to introduce a flat tax before the 2001 elections, but even promoted it as an important reason why people should vote for them (see e.g. *Dagbladet* 2001). The disappointing election results did not give the Liberals as much influence in the new government as they had hoped for. It was thus understandable that the party leaders were willing to look at alternative ways of removing the split model, which by then had become something of a hate object for the Liberal Party, who wanted to make life easier for small businesses. One may however question how deep Sponheim’s own commitment to the flat tax proposal really went. After the

government had presented the tax reform, Sponheim publicly announced that his party needed to start a new debate on whether flat tax really should be the end goal (Hansen 2004). He said that the party for the last 12 years had been criticized for promoting the flat tax because the proposal “actually gives most tax cuts to the rich” (Dagens Næringsliv 2004). If the government managed to implement their suggested reform, however, he no longer saw “the need for a flat tax in Norway” (ibid). Sponheim’s statement that “much of the Liberal Party’s policy on this area has been on a rhetorical level” (quoted in Hansen 2004) cast further doubt to whether he had even tried to get support for the proposal among the coalition partners. Olsen (2006 [interview]) also admits that though the proposal is still in their program, “more and more people in the Liberal Party see that the flat tax is a vision that lies quite far ahead in time”. Furthermore, Olsen even doubts whether the flat tax would have been introduced during the four-year period even if his party had had a majority in the parliament, claiming that the proposal would anyway have had to be introduced gradually over longer time than a parliamentary period (ibid).

Although the Conservative Party’s program could be interpreted as aiming for a flat tax, the minister of finance Per-Kristian Foss clearly felt that such a move was neither realistic nor desirable. The most important person behind any tax reform was thus clearly against the proposal. Furthermore, the Prime Minister belonged to the Christian Democratic Party, which evidently did not support any move to flat tax and would prefer to limit the overall tax cuts. Any pressure to make the finance minister change his mind would therefore at least not come from him. In short, the flat tax proposal seems to have lacked a centrally placed policy entrepreneur that could assert the necessary influence in order to push the proposal towards implementation.

5. Comparing the cases

The presumption of this study was that both Estonia under the Laar 1 government and Norway under the Bondevik 2 government experienced a “policy window” allowing for a reform of the tax system. Following the flat tax proposal, my aim was to explain why the policy window was used to carry out this particular proposal in Estonia but not in Norway. The theoretical discussion in chapter two resulted in seven expectations as to what I would find in the empirical chapters, related to the problem the proposal was connected to, its value acceptability, technical and political feasibility, budgetary implications, the political conditions, the policy entrepreneurs and the size of the policy window. I will go through each of them in turn.

The first expectation from the theory chapter was that which problem or problems the flat tax was connected to would make a difference. As we have seen, the problem that the flat tax was supposed to solve in Norway was the fact that there was a gap between the taxation of capital and the taxation of salaries in the existing system. Because the “split model” did not satisfactorily bridge this gap, it was possible to make adaptations in order to have labor income taxed as capital income. This was perceived as both unfair and inefficient by the Norwegian decision makers and they wanted to do something about it. The problems connected to the flat tax in Estonia seem however to have been of a much more serious kind. The tax administration lacked both the necessary resources and the experience to administrate, not to mention control, the kind of complex tax systems that were common in the West. Tax payers were not used to pay taxes, but had grown accustomed to a society where constantly trying to “fool” the system was socially acceptable. Tax evasion thus quickly became a huge problem. The problem with the dysfunctional split model in Norway was, as Steensnæs (2006 [interview]) put it, “disturbing”. However, the mere fact that it took more than ten years before it was finally replaced with another model suggests that the problem was not considered very urgent. A state that does not manage to make its citizens pay the taxes regulated by the law will on the other hand

eventually cease to function. Finding a solution to the problem of tax evasion in Estonia was thus seen as extremely urgent. Furthermore, the hyperinflation at the time of the tax reform made a progressive tax system quite unpractical, as the brackets would have to be changed constantly to avoid taxing the whole population with the highest rate.

There is no doubt that substantial amounts of taxes are illegally evaded in Norway each year. However, though the Liberal Party at times mentioned it as an argument in favor of the flat tax, it does not seem like tax evasion at the time was something that the politicians believed they “should and could do something about”. Thus, following Kingdon’s (1994:218) definition, it was merely a “condition” and not a “problem”. Inflation has not bothered Norway for many years and thus did not even constitute a condition. In Estonia on the other hand, the gap between the taxation of labor and the taxation of capital seems to have been completely absent from the political agenda. In fact, as the country had a very high rate on the social tax paid by the employer, the system still encouraged people to direct their earnings to a company and to take it out as dividends without paying social tax, *even after the flat tax was introduced*. The flat tax proposal thus did not solve in Estonia the problem, or rather the condition, that it was attempted connected to in Norway¹⁶. The problems on the agenda in Estonia were so serious that even a radical proposal was considered in order to solve them. In Norway on the other hand, it seems that the problem was simply not perceived as being serious enough to justify a far-reaching reform like the flat tax. The policy makers thus continued the search for a different solution, and found a model that they believed would solve the problem in a more politically acceptable way.

This was perhaps most of all due to the fact that, as the second expectation stated, the flat tax proposal was judged as being “unfair” by many of the key Norwegian decision makers. One of my main findings is that tax reforms in Norway are clearly

¹⁶ According to Erki Uustalu (2006, [e-mail]), advisor in the Estonian Ministry of Finance, this problem is only now being discussed, more than ten years after the flat tax reform.

judged according to how the changes are distributed between income groups. Because these comparisons are normally done between different groups of *wage earners*, calculations would show that the flat tax would give unreasonably big tax cut to the ones with the highest income compared to those earning less. This particular framing of the changes made the fact that most of the *richest* individuals in the country would most likely get a tax *increase* with a flat tax seem to be of less importance. Some of the strongest proponents of the flat tax realized that if they wanted the proposal to be accepted as “fair” they needed to make sure that “everybody” would get a tax cut. In Estonia at the time of the tax reform on the other hand, it hardly made any sense to talk of rich and poor and how a tax reform would affect different income groups. The differences in income were small and almost everybody was poor. Furthermore, as Lauristin (2005 [interview]) put it, they had no “fixed ideas on what is just and what is not just”. The Estonians wanted to quickly turn away from the system that they had been forced to live under, which meant that working hard was rarely rewarded. A proposal that would not punish someone for earning a little more therefore seemed to be consistent with the policy makers’ way of thinking. In Norway on the other hand, key policy makers had a clear conviction that the tax system could and should be used for income redistribution. Most of them had become convinced that the mobility of capital puts limits to how much you can tax the truly rich. However, the norm that the tax system should be redistributing was so strong that rather than abandoning the idea, Norwegian policy makers have decided that they will be satisfied if they can redistribute from the upper middleclass and down.

In the theory chapter I expected that the “technical feasibility” of the flat tax proposal would be an important argument in favor of the flat tax. This seems indeed to have been the case in both Estonia and Norway. The simplicity of the flat tax was the most important argument in Estonia, as it was this in itself that was supposed to solve the main problem of tax evasions. In Norway even those who opposed the flat tax acknowledged that such a proposal had its strength in its simplicity. This great technical feasibility was however overshadowed by the fact that the proposal was not

seen as “politically feasible” by most policy makers, because such a proposal included a removal of all the current tax exemptions. The study has showed that removing the exemptions, most importantly the one on interest payments, seems to be politically almost impossible. The flat tax proposal’s lack of political feasibility may therefore have meant that even those who *in principle* may have seen the flat tax as a better system have been convinced that such a reform is *unrealistic*. Even the clear supporters of the flat tax seem to have accepted that the deduction on interest payments would have had to stay in place even if the flat tax was to be carried out. In Estonia, on the other hand, this was the least of their worries. The exemptions were few and the short period of the existing tax system meant that they had not been much used. Removing them did therefore not seem to cause much opposition.

If the proponents of the flat tax in Norway wanted to leave the tax exemptions in place, this would however further add to the cost that the flat tax would have in terms of revenue. This and the earlier mentioned need to make sure that “everybody” would get a tax cut in connection with the reform would mean that the flat tax would be extremely expensive in Norway. My fourth expectation was that the uncertainty of the alleged positive effects of the flat tax, and thereby the necessary size of revenue cuts, would be an important barrier against such a reform. Indeed, as we have seen, none of the decision makers seems to have been willing to base their calculations on the costs of the proposal on the existence of such effects. This uncertainty was definitely a major argument against the flat tax also in Estonia, and the international advisers did their best to convince the decision makers that it would be unwise to take such effects for granted. In Norway the debate circled around the efficiency effects a flat tax would have on the labor market. Other arguments, like reductions in the black market or reduced bureaucracy as a result of a simpler system, were considered less relevant. In Estonia on the other hand, as the main problem to be solved was the amount of illegal tax avoidance, they had a more reasonable hope that the proposal would give an increase in revenue because more people would pay taxes. Moreover, the government was not filled with the experienced, risk-averse politicians of

established democracies. On the contrary, it was a group of young radicals who knew very little about economics but who were willing to “stick their necks out”.

The fifth expectation of the theory chapter dealt with the “political stream”. In terms of election results, both Estonia and Norway experienced “swings to the right” in the elections preceding the tax reforms. This was however much more pronounced in Estonia, where none of the parties even wanted to be called “leftist”. Though the Estonian government included a party which called themselves Social Democrats, the policies they pursued were radically rightist on almost all areas. In Norway, on the other hand, the left-wing Socialist Left Party had also been one of the election winners. More importantly, the Christian Democrats had originally wanted to form a centrist government, and only hesitantly agreed to enter the new centre-right government. They had also made it clear that they did not want tax cuts anywhere close to the amounts that the Conservatives had promised. Taxation had been an important issue in the election campaign and tax cuts enjoyed a strong support in the public opinion in Norway at the time of the 2001 elections, but it seems like this support had faded considerably by the time the government was to implement their tax reform. In Estonia, tax questions and economic issues in general played a smaller role in the election campaign, but the unfamiliarity with the whole concept of having to pay income taxes ensured that tax cuts would be popular. All in all however, I have found little evidence that confirms the expectation that Estonia would have experienced a public mood *more* favorable to tax cuts than what was the case in Norway. When it comes to the role of interest groups on the other hand, the difference is again very clear. In Norway the government took great care to make sure that all relevant groups would be allowed to give their comments on the proposals under consideration. Though I have not investigated closer the extent of the influence of these groups, it is reasonable to assume that their objections at least did not make it easier to remove tax deductions no longer seen as needed by the policy makers. In Estonia, on the other hand, organized interest groups had yet to be developed, and the proposal for tax reform was not even sent on any public hearing.

The sixth expectation of this thesis was that the position of the actor or actors who promoted the flat tax proposal would make a difference. In Estonia it is clear that the “policy entrepreneur” mostly responsible for pushing the proposal to the agenda held the most powerful position of all, namely the post of prime minister. From this position Mart Laar made sure that the proposal was written into the coalition agreement, and that the reform went ahead as fast, or rather faster, than practically possible. The proposal also had a strong advocate in the parliament in Heiki Kranich. In Norway on the other hand, the supporters of the flat tax were not to be found in any of these influential positions. The disappointing election results of the Liberal Party which had actively promoted the flat tax, made it difficult for the party leader Sponheim to assert much influence on the choice of tax reform. As we have seen, there are also reasons to believe that his conviction that the flat tax was indeed the right solution was rather weak. Carl I. Hagen of the Progress Party on the other hand, was not allowed into government and could not participate in the preparations of the reform. The lack of will to publicly promote the flat tax suggests that Hagen at any rate did not really fill the requirements of Kingdon’s definition of a “policy entrepreneur”. Rather it seems like none of the influential Norwegian policy makers had the “willingness to invest” time, energy and reputation in order to introduce the flat tax proposal. This was clearly different from the Estonian situation. Prime Minister Laar knew that the proposal would be unpopular, but he believed so strongly that it was the right thing to do that he was willing to sacrifice his personal popularity. He knew that if the tax reform failed and the expected tax revenues did not materialize, it would destroy his reputation. But he was willing to take that chance.

Both of the cases did experience a “policy window” offering policy makers the chance to reform their tax systems. My final expectation was however that I would find that in Estonia this window was a “macro-window” opening for more radical reforms, while the window in the Norwegian case was considerably smaller. Following Keeler (1993) I expected that a great policy window could be caused by seven mechanisms: the authorization, the empowerment, the party pressure, the

crisis-mandate, the urgency, the fear and the limited attention mechanism. None of the governments in question was brought to power by any landslide election, and the *empowerment mechanism* thus did not contribute to any “macro-window”. The Bondevik 2 government was a minority government which did not even have a clear support in parliament. However, it seemed clear that the tax question was partly to blame for the crushing defeat of the Social Democrats and the good election results of the rightist parties. Despite the lack of a clear majority support this gave an impression that the government was authorized by the public to reform the tax system, and it might be argued that the *authorization mechanism* contributed to a greater window. The Laar government, on the other hand, with only a one-vote majority behind it in parliament, enjoyed an additional authority from the fact that it was the first truly democratic government that the country had experienced in almost sixty years. The government had great ambitions for how it was going to turn the country towards the West and away from its Soviet past. The expectations for a quick turnaround also meant that many of the government’s supporters were impatient to see their policies through. According to Laar there was a strong pressure from party members who were critical that the flat tax was not introduced already the first year. In other words, it seems like the *party pressure mechanism* played a role.

But the reason why the policy window for reform was indeed much greater in the Estonian case is without a doubt the mechanisms connected to the existence of a *crisis*. The *urgency mechanism* was clearly important in opening the way for a radical reform. The government needed to do something quickly to make sure more people actually paid their taxes, and there was indeed an “assumption that serious problems will get worse if nothing is done” (Keeler 1993:441). However, the most important mechanism at work seems to have been my addition to Keeler’s theory, namely what I called the *limited attention mechanism*. A radical proposal to change the entire tax system and do something that has never been tried before in any European country would under normal circumstances at the very least create heated public debate. Instead it seems like the situation of a general crisis meant that the tax reform was hardly noticed. The media had so many things to write and talk about that it was easy

to leave out a complicated issue like taxation. For most ordinary people life was so hard that they had enough with worrying about surviving. The effect also influenced the politicians themselves. The ministers were simply too busy solving urgent problems in their own field to have time to interfere in anybody else's business. Even the members of parliament had to choose carefully what they wanted to prioritize to dig further into, and as most of them knew very little about economics, it was an easy choice to not bother too much about the tax policy.

Although the Bondevik 2 government evidently didn't experience a "macro-window", the elections did give the government a policy window to reform the tax system. Another striking difference between the two cases is however the speed of the reform. In Norway, making changes that would allow for the removal of the split model had been discussed since the model was introduced in 1992. One would think that after the "swing to the right" in the elections in 2001, the government would be able to quickly introduce a prepared solution to the problem. Instead the government started a slow process, appointing a committee that used a whole year to prepare a report, then waiting another year before coming with a proposal of their own, which again implied that the reform would only be fully introduced after the next parliamentary election. The government thus risked not even being able to implement the reform, but through reaching out for support from the Left it ensured that at least the most important features would survive if there should be a change in government. The slow pace of the reform process also meant that the public mood had time to change. The reform was thus almost jeopardized by the fact that by the end of the period it seems the public support for tax cuts had all but disappeared, at least if the cuts were to go to the highest earners. Cutting the top marginal tax rates against the wishes of the public opinion was in fact very likely an important cause of the dramatic loss the Bondevik 2 government suffered in the 2005 elections. In Estonia on the other hand, Prime Minister Laar *knew* that he had a window of opportunity that would not last forever. He thus moved quickly to use the historic opportunity efficiently. And though it perhaps seemed completely naive at the time, the hurry paid off.

6. Conclusion

The empirical ambition of this thesis was to give a comprehensive explanation of why the flat tax has been introduced in Estonia but not in Norway. I have done this by choosing as cases the “policy windows” that opened for a tax reform in Estonia under the Laar 1 government and in Norway under the Bondevik 2 government and examining the factors that contributed to the flat tax proposal being adopted only in the first case. The preceding chapter has already summed up the basic findings from the case studies. We have seen that the assumptions provided by the theory chapter were largely fulfilled, and that my extension of the Multiple Streams model with the path dependence theory provides fruitful explanations. This chapter will first discuss some of the implications of the theoretical and methodological choices that I have made. The study has emphasized the mechanisms which may explain why a particular proposal may or may not be adopted. As an illustration of how these mechanisms work I will, perhaps a bit untraditionally, include a short discussion on whether it would at all be possible to introduce the flat tax in Norway. The second part of the conclusion will deal with the question of the generalizability of my findings, that is, whether the study has brought us any closer to an understanding of why the flat tax so far has only been introduced in Central and Eastern Europe.

The Multiple Streams model assumes that the causes of significant reforms have a “conjunctural” nature, that is, the change results from an *intersection* of appropriate conditions (Ragin 1987:25). The theory claims that certain preconditions *must* be in place in order for a reform to be adopted. The logical counterpart is that if only one of the factors is missing, it is enough to stop the whole reform. Is that reasonable to assume in our cases? Would one missing condition have been enough to stop the adoption of the flat tax in Estonia? When it comes to the basic preconditions that Kingdon (1994:216) stated, that a problem needs to be recognized and connected to the proposal in a situation of favorable political conditions, I believe the answer is yes. However, this study has in fact shown that *both* of the cases could be said to

have fulfilled the model's basic preconditions. Also in Norway, there *was* a problem that could be connected to the proposal, the proposal *was* available, the political conditions *were* favorable to a tax reform, opening a policy window for reform, and there *were* policy entrepreneurs who, at least rhetorically, wanted to introduce the proposal. The explanation for why the proposal was still not adopted in Norway is in my opinion primarily to be found in the problems the proposal had with fulfilling the "survival criteria". The most important obstacle seems to have been the "value acceptability" of the proposal. The extent to which an alternative proposal for a new tax system is judged according to the size of the tax changes it will entail for different income groups is perhaps my most interesting finding, and the way Norwegian policy makers judge fairness is indeed a subject that would deserve further study. We have seen that when introducing the 2006 tax reform both the Bondevik 2 government and the Progress Party were extremely concerned that the tax changes had to be *balanced*. The goal was that the lowest earners should get tax cuts comparable to the highest earners. My respondents seem to agree that the flat tax would have had to be introduced according to the same thinking. This, together with the difficulties involved in removing tax exemptions, consequently aggravated the problems the proposal faced with the third survival criteria, "budgetary implications". However, what really killed the flat tax proposal was the fact that the method of comparing changes seems to be restricted to *wage earners*. Because the "rich" is defined as the ones with high salaries, the flat tax has been *framed* as a proposal that gives too much to the rich. In reality however, most possible flat tax schemes would most likely give the *real* rich a net tax increase.

Do the survival criteria and the way they are shaped by path dependence mechanisms pose obstacles that make it *impossible* to introduce the flat tax in Norway? Not necessarily. I have added to the Multiple Streams model an emphasis on the fact that the basic preconditions of the Multiple Streams model may be fulfilled to *different degrees*. In other words, the *seriousness* of the problem, the *extent* to which the political conditions are favorable to reform, the *centrality* and strength of the policy entrepreneurs and the *size* of the policy window all make a difference. It is perhaps

not likely that Norway will face a general crisis anywhere close to the situation that created an exceptionally large policy window in Estonia at the beginning of the nineties. However, political conditions, like a landslide election victory for the rightist parties, may still open a “macro-window” for reform. Such a victory may bring into central positions one or several actors who really believe in the flat tax and who, following the definition of real policy entrepreneurs, are willing to invest their time, energy and reputation to see it through. A clever policy entrepreneur may be able to frame the proposal in a different way than what has been done so far, and thereby overcome the challenges the flat tax has experienced when it comes to fairness. He or she would have to explain the unfairness of the current system in a manner understandable to people with little knowledge of the area of taxation. The tax exemptions on interest payments could on the other hand be gradually faced out by putting a ceiling which would only apply to loans above a very large amount (e.g. 5-7 million NOK). Such a scheme would affect so few people that it is not likely to cause much protest and it would therefore be much more politically feasible¹⁷. After the ceiling has been introduced, it could gradually be lowered, if nothing else than through the simple process of bracket creep. A gradual reduction of the deduction on interest payments would also make it easier for the proposal to survive the budgetary implications criterion. In any case, the current growth in the Norwegian economy would allow a rightist government to introduce substantial tax cuts without unpopular cuts in welfare, even within the guidelines for a sustainable increase in the use of petroleum revenues. The proposal could finally be strengthened by coupling it to a problem seen as more serious by larger groups of the population than what was the case with the fairly technical question of the problems with the split model. As we have seen, the issue of illegal tax evasions has been largely absent from the Norwegian agenda, while the question of legal tax avoidance has been mostly restricted to the debate on the split model. However, when it comes to laws and

¹⁷ In the summer of 2006 high-ranking members of the Centre party actually suggested a ceiling on the deduction of interest payments (Johansen and Larsen-Vonstett 2006). The proposed ceiling of 2 million NOK would however affect a very large number of people, and the proposal was quickly condemned by politicians from all other parties.

regulations, most people often act as “contingent compliers”. That is, they are “prepared to comply with common, fair rules as long as they believe that others will do so as well” (Føllesdal 2006:161). In other words, people’s willingness to pay taxes depends to a large extent on whether they think most others do. If people start getting the impression that the rich do not pay their fair share, or that a large number of people evade taxes and get away with it, the whole tax morale of the population may become seriously damaged. If something (e.g. a major scandal) would bring the problem of tax evasion and morally dubious tax avoidance higher on the agenda and the serious consequences it may have would become clearer, the simplicity of the flat tax could be presented as the solution to it. In other words, in a situation of a large policy window, skillful policy entrepreneurs in the right positions who are able to frame the fairness of the flat tax in a different way and couple the proposal to a problem seen as serious enough, might perhaps manage to “make the earth flat”, also in Norway.

As I emphasized in the introduction, case studies of only two countries do not provide results that are *generalizable* to the whole universe of European states. My claim was rather that the results that I would find would be *relevant* to the understanding of the greater empirical backdrop, that is, why the flat tax so far has only been introduced in Central and Eastern Europe, but not in any Western European country. My findings suggest that the main obstacles to the introduction of a flat tax in Norway have been the proposal’s difficulties when it came to fulfilling three basic survival criteria, and that this to a large extent is the result of path dependence mechanisms that inhibit change. Many of the features that caused these difficulties in Norway are however common to most Western European countries. They have all had progressive tax systems for very many years and most of them are complicated and not easily understood by the citizens. They also generally have several deduction possibilities, although many have ceilings or other limits on how much one can deduct. And decision makers would face the same kind of insecurity regarding how much revenue cuts a flat tax would necessitate. Western European countries’ tax systems and institutions obviously also have important differences, and the national cultures and

conceptions of fairness may in many ways be very different from the ones found in Norway. I will however argue that it is reasonable to assume that similar mechanisms to those we have seen in the Norwegian case cause problems for the survival criteria of the flat tax proposal also in other Western European countries.

The Central and Eastern European countries on the other hand, all introduced Western types of taxation systems only after the transition to democracy and capitalism in the beginning of the nineties. Like in Estonia, we would expect that the shorter history of progressive taxation meant that fewer path dependence mechanisms were present, and that this made it easier for the flat tax proposal to fulfill the survival criteria. Moreover, these countries all experienced the same problem of having to build up new tax administrations and accustoming the general public to the need to pay taxes. It is therefore reasonable to assume that potential policy entrepreneurs have been able to present the simplicity of the flat tax as a solution to this problem. None of the Western European countries have in recent years experienced crises anywhere close to the severity that the transitional countries in Central and Eastern Europe faced at the beginning of the nineties. We would therefore not expect any of them to have experienced the kind of “macro-window” that the Estonian decision makers took advantage of. On the other hand, several of the Central and Eastern European countries introduced the flat tax *after* the worst economical and political crises were already over. Thus they did not perhaps either experience policy windows of quite the same size as Estonia at the time of their reforms. It is however reasonable to assume that copying a system that had already been introduced in one or several neighboring countries has been easier than to be the first country to try something which until then had been considered merely a theoretical proposal. We have seen that the obstacle that concerned the Estonian decision makers the most was the “budgetary implications” criterion. These fears proved to be ungrounded, and, knowing this, it is likely that the decision makers in the countries that have since followed in Estonia’s tracks have been less worried about the consequences for the budget. It is therefore reasonable to assume that a “macro-windows” of the extraordinary size that Estonia experienced has been less needed.

Epilogue: Looking into the future...

Will the “flat tax revolution” spread to Western Europe and Norway? Or are Estonia and Eastern Europe only experiencing a limited period in which tax competition demands simple tax systems that will later be replaced by progressive systems as the revenue demands of more developed welfare states’ increase? At the time of writing, the Progress Party is Norway’s biggest party in most opinion polls and the party’s new leader Siv Jensen is the most popular prime minister candidate of the opposition. If the next elections were to see the Progress Party sweep into power for the first time, this would be a historic incident which may very well open a policy window for radical changes. The Liberals and the Christian Democrats are however still resisting all invitations for closer co-operation, and even the Conservatives are hesitant when it comes to the prospects of a rightist coalition government. As we have seen, a flat tax as envisioned by the Progress Party would be very expensive, as it would have to leave important exemptions intact and have a rate and a personal allowance that give tax cuts to “everybody”. To enter into a coalition government it is clear that the Progress Party would have to set aside their most controversial policies. The party has made many expensive promises, both when it comes to increased spending and reduction of other taxes and excises. It is therefore doubtful that the party would prioritize a politically difficult issue as the flat tax, which they have so far barely dared to promote publicly. In Estonia on the other hand, the Centre Party and the People’s Union recently signed an agreement over a common candidate in this year’s president elections, which also included agreeing to re-introduce a progressive tax system. Some polls show that these parties may indeed be able to form a majority government together after next year’s parliament elections. The Centre Party has promised to introduce progressive taxation many times before without doing anything about it once in government. But, as we have seen in the Norwegian case, it is much easier to introduce new progressive tax rates than to remove them. Though it is always risky to try to predict the future, it seems that at least when it comes to these two countries, any convergence in tax policy in the nearest future is most likely to come in the form of a re-introduction of progressive taxation in Estonia.

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